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An Analysis of the Statutory Regulation of Fraudulent Trading

Henry Mikolaj Skudra

University College, University of Durham

Research conducted at Durham Law School, University of Durham

This thesis is submitted in fulfilment of the requirements for the degree of
Master of Jurisprudence.

November 2011

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Acknowledgments

I wish to thank my supervisors Mr. Chris Riley and Professor Christian Witting for their advice, encouragement and guidance throughout my research.

I am also grateful to my friends and my fellow researchers at Durham Law School whose support and friendship during this year has been magnificent.

Abstract

Fraudulent trading is a concept embodied most unusually in two almost identical provisions on the Statute Book. From its humble beginnings as a single umbrella provision used as a means by which creditors recouped their assets and delinquent directors who defrauded creditors were punished, it has morphed and evolved. This evolution has produced two separate provisions in the civil and criminal arenas and has given rise to academic uncertainty surrounding the purpose, meaning and future of fraudulent trading.

Setting the scene and context surrounding the notion of fraudulent trading enables these questions to be then more easily addressed and it is highlighted that it is an unusual but worthwhile tool as a means of recovering assets. Questions still remain over whether criminal fraudulent trading will (eventually) perhaps eclipse its civil law statutory sibling given its procedural and jurisprudential advantages, immense prevalence and the post-conviction options now available to the Courts provided by recent legislation. In the final analysis however, Parliamentary resolve will be required for this to occur and it does not, at the moment, appear to be forthcoming.

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List of Abbreviations

BLJ: Banking Law Journal

CLJ: Cambridge Law Journal

CLR: Cambridge Law Review

CLWR: Common Law World Review

Crim LR: Criminal Law Review

ECHR: European Convention on Human Rights

HC: House of Commons

HL: House of Lords

ICCLR: International Company and Commercial Law Review

InsO: 1994 Insolvency Statute (*Insolvenzordnung*) (Germany)

JBL: Journal of Business Law

LMCLQ: Lloyd's Maritime and Commercial Law Quarterly

LQR: Law Quarterly Review

MLR: Modern Law Review

NLJ: New Law Journal

OJLS: Oxford Journal of Legal Studies

Introduction

Outline

Companies are constantly subjected to financial stresses and pressures as a normal part of business life. A major source of such pressure is that arising from business debts and/or liabilities whereby the company owes money to one or more creditors¹.

When, however, a company fails to keep up with its debt repayments or voluntarily is to be brought to an end, the company is wound up². Winding up can occur following a petition from creditors, members or directors and during this legal and administrative process, its debts and liabilities are assessed and must be contributed towards by members past and present³. Normally, and as according to the principles of limited liability, this contribution will be exceptionally narrow and amount to either a nominal sum or will be the monies which the shareholder(s) paid for his or her shares.

Very often there are insufficient remaining assets for the company, even when liquidated, to fully repay its creditors and so they will try and recover their losses by piercing the corporate veil and extracting funds from the company's directors; almost always through the medium of an insolvency professional. To illustrate the potential extent of the problem, there were in England and Wales in the second quarter of 2010, a total of 4, 080 compulsory and creditors' voluntary liquidations⁴ with a noticeable rise from 2008 since the Recession. Indeed, Goode aptly highlights this in his latest authoritative work on corporate insolvency law when he identifies a stark rise from 12, 507 liquidations in 2007 up to 15, 535 in 2008 and 19, 077 in 2009⁵ as the Recession hit home.

¹ A creditor being a natural or legal person with a pecuniary claim against a company *per* Lord Mackay of Clashfern (ed), *Halsbury's Laws of England: Volume 15* (5th edn, Lexis Nexis, London 2009), para [1427].

² See Part IV of the Insolvency Act 1986.

³ Insolvency Act 1986, s.74. See generally- R. Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell, London 2011), [1-39]-[1-57].

⁴ The Insolvency Service, 'Insolvency Statistics: Company Insolvencies' <<http://www.insolvency.gov.uk/otherinformation/statistics/201008/index.htm>> accessed 1st November 2010.

⁵ R. Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell, London 2011), [1-31].

The issue of creditors recouping their losses is highly relevant given the modern financial climate with the U.K. recently coming out of recession, persistent very low economic growth and with very many loans and other financial instruments of credit “going bad”⁶.

However, there is a multitude of ways in which creditors can attempt to recoup their losses by piercing the corporate veil. These include a finding that the company is a mere façade/sham, a finding of implied agency⁷, contractual agreements and statutory requirements that the veil be lifted⁸. One of these statutory requirements is where fraudulent trading has been proven. Fraudulent trading comes in the form of both criminal⁹ and civil¹⁰ provisions and both lead to defendants potentially being liable to make a contribution to the assets of the (now normally wound up) company in one manner or another.

It is especially noteworthy that assets recovered under s.213 actions are distributed *pari passu* with chargeholders not being prioritised. This, as Keay eruditely highlights, is due to the fact that liquidators who are solely permitted to bring s.213 actions act, although on behalf of creditors, in their own legal capacity and it is not the company bringing the action¹¹. The position is the same for criminal fraudulent trading, as will be seen below in this thesis¹².

Of further importance is the fact that both natural and legal persons can be held accountable; thus enabling higher-worth companies to be targeted as well as individuals. This is crucial given that other creditor remedies are much more restrictive in who they can hold to account.

It is also essential to bear in mind that fraudulent behaviour holds much more serious standing within the Law of England and Wales than any other forms of proscribed transacting. This is highlighted by the lengthier and more severe punishments and penalties which it attracts. It is submitted that the activity of inducing more credit to be given to a failing company in the knowledge that creditors have little or no chance of recouping their assets ranks amongst the most economically dangerous of business mischiefs.

⁶ Indeed, at the time of writing, a new global financial crisis has emerged and brings with it extremely poor growth figures and the danger of re-entry in economic recession- a so-called “double-dip recession”.

⁷ For a full and authoritative enunciation of these principles see *Adams v Cape Industries PLC* [1990] Ch 433.

⁸ M. Moore, “‘A Temple Built On Faulty Foundations’: Piercing the Corporate Veil and the Legacy of *Salomon v Salomon*” [2006] JBL 180.

⁹ Under the Companies Act 2006, s.993.

¹⁰ Under the Insolvency Act 1986, s.213.

¹¹ A. Keay, *Company Directors’ Responsibilities to Creditors* (Routledge-Cavendish, Abingdon 2007), 48-49.

¹² Assets in compensation orders following conviction are distributed *pari passu*. Whilst those holding proprietary interests may remove some assets from those defendants who are subject to a restraint order under the Proceeds of Crime Act 2002 process. Creditors in our context hold their interests against the company which has been or is being wound up and **not** the convicted defendant. See [4.3.2] below.

This is because the importance of relatively cheap and available credit should not be underestimated. If creditors never have any prospect of recovering their assets when companies default on loans, then the price of credit will drastically increase¹³ - with dire economic consequences. The most rapid and easily-accessible way in which Government policymakers (perhaps with the advice of the Bank of England) can prevent creditors taking on too much risk and thus pricing their credit at a much higher level, is through statute law¹⁴.

The arguments and extent of the enquiry in this thesis

This thesis will begin by first setting out the relevance and context of fraudulent trading because, as a creditor remedy, it might be argued that it is redundant given the *prima facie* easier option of using wrongful trading¹⁵ to recoup assets.

Though it will be shown, both in the first chapter and as a continuing theme throughout, that fraudulent trading as a whole is a more effective and useful set of remedies in several different senses. It must be borne in mind that the enquiry is limited to fraudulent trading only; the carrying out of a full and thorough analysis of wrongful trading is unfortunately limited by space.

Then, to fully analyse and bring to the surface arguments which will be made relating to the true nature and jurisprudential heritage of fraudulent trading, the history and development of it will be undertaken.

A more meaningful analysis can then be extracted from this and from both the history and scrutiny of the two fraudulent trading provisions. It will then be contended that both provisions are separately effective in their own different manners. Criminal fraudulent trading especially has come into its own and civil fraudulent trading continues to be a useful tool for liquidators to fill otherwise fairly empty "assets pots". The thesis will then conclude with a brief overall assessment of the provisions and will also seek to hypothesise about their future direction as well.

¹³ See for example- M.R. Roberts and A. Sufi, 'Control Rights and Capital Structure: An Empirical Investigation' (2009) 64 Journal of Finance 1657; D. Citron and M. Wright, 'Bankruptcy Costs, Leverage and Multiple Secured Creditors: the Case of Management Buy-outs' (2008) 38 Accounting and Business Research 71; B.C. Esty and W.L. Megginson, 'Creditor Rights, Enforcement, and Debt Ownership Structure: Evidence from the Global Syndicated Loan Market' (2003) 38 Journal of Financial and Quantitative Analysis 37 and K.-H. Bae and V.K. Goyal, 'Creditor Rights, Enforcement, and Bank Loans' (2009) 64 Journal of Finance 823.

¹⁴ J. Qian and P.E. Strahan, 'How Laws and Institutions Shape Financial Contracts: The Case of Bank Loans' (2007) 62 Journal of Finance 2803.

¹⁵ Under the Insolvency Act 1986, s.214.

Chapter Outlines

The first chapter will set the general scene and place fraudulent trading within a greater context as well as dealing with potential concerns over its continued place within the insolvency legislative framework. It will be seen that its continued viability is assured both as a result of traits inherent in civil and criminal fraudulent trading as well as failures in other putative remedies to adequately deal with fraudulent trading behaviour to the far-reaching extent of the current fraudulent trading provisions.

Chapter two leads us into examining the history and development of the concept which has grown and developed from humble beginnings. Along the way, significant features in fraudulent trading's jurisprudential ancestry are revealed and brought to the fore. Furthermore, having looked at the provision historically, a much better understanding of where it is headed can be gained which proves extremely useful for analysis later in the thesis.

The third of the five main chapters looks at both civil and criminal fraudulent trading provisions analytically. Using features espoused in the first two chapters as well as in-depth scrutiny of the make-up of both civil and criminal fraudulent trading, chapter three picks out and highlights their various features and problematics. It will be seen that jurisprudential and practical problems surround s.213 of the Insolvency Act 1986 which can be potentially remedied with reference to s.993 of the Companies Act 2006. However it is emphasised that criminal fraudulent trading does not necessarily represent a panacea.

With the possibility of s.993 entirely replacing civil fraudulent trading as a background theme, chapter four contrasts s.993 and s.213. This is conducted along several different strands including comparisons of a practical and jurisprudential nature as well as looking what is realistically and pragmatically achievable by both provisions. It uncovers the practical reasons as to why s.993 of the Companies Act may not be the panacea it *prima facie* appeared to be.

The fifth and final chapter looks ahead to where both types of fraudulent trading provision might be heading in the future. By drawing upon the rest of this work, the chapter puts forward hypothetical directions in which fraudulent trading should go and suggests that ultimately s.213 civil fraudulent trading, despite many reservations, is to remain on the Statute Book.

There is also a set of appendices setting out the relevant parts of the unfamiliar historical fraudulent trading provisions as originally enacted. This is to help guide the reader through the legislative history of the concept without them having to always delve into old copies of Parliamentary Statutes.

Chapter One:

The Context of Creditor Remedies- The Stunned Elephant

1.1-Introduction

By way of caveat, this thesis will **not** be examining all available remedies for creditors where fraudulent trading-esque behaviour has occurred, yet the context of this thesis is as follows:

Imagine a group of creditors who see their lent assets in a company lost- almost certainly, they suspect, due to fraud or near-fraudulent mischief on behalf of the managers or those controlling the company¹. We can imagine them at a cross-road. Ahead of them they find a remedy for fraudulent trading² available, to the left wrongful trading³ and to the right one for the tort of deceit.

All of these actions will allow them to pierce the corporate veil and potentially seize the personal assets from those who were participating in the running of the company. Yet following each path has its own drawbacks. The first, fraudulent trading, is itself split in to two branches. On the first branch, there are criminal law proceedings which form the widest, longest and most well-trodden path of recent time; though almost always entry to this path is permitted only with the consent of the Director of Public Prosecutions. Yet it will be submitted that this, whilst not always the most practical path to follow, is nonetheless an extremely important tool in regulating corporate behaviour and deterring fraudulent trading.

On the second branch of fraudulent trading there is a gatekeeper in the form of a liquidator who is the only one with *locus standi* to bring an action under either s.213 or s.214 (wrongful trading) of the Insolvency Act 1986⁴. This branch of the path, rather like wrongful trading, has become overgrown and unkempt through a lack of those prepared to tread this path; even though it is an older route. Yet this and its criminal law counterpart⁵ will both form the subject of this thesis.

This very same gatekeeper also restricts access to the left path, wrongful trading. Whilst *prima facie* the path on the left is much smoother than that of its statutory neighbour, it is a far narrower path

¹ N.B.- importantly not just directors.

² Under either the Companies Act 2006, s.993 in the criminal courts or under the Insolvency Act 1986, s.213 in the civil context.

³ Insolvency Act 1986, s.214.

⁴ Although this was not always the case and has only been so since that Act- see the elaboration below at [2.3.7].

⁵ To be found under the Companies Act 2006, s.993.

as it only captures the wrongdoing of directors⁶. Creditors are thus unable to get at the juicy assets which may lie in the hands of others and in the area covered by fraudulent, but not wrongful trading.

The tort of deceit path on the right is narrower than fraudulent trading but wider than wrongful trading. It is not immediately all that obvious as a route, yet Goode and other commentators have raised it as a possibility as:

An individual creditor suffering loss as the result of ... fraudulent trading may also have a remedy...through an action for deceit, as where the director obtains goods or services for the company by making an express or implied representation in **writing** that the company is solvent.⁷

Yet it has a toll booth. For in order to bring an action in deceit, a creditor must fund it themselves which can be a very expensive process indeed- especially if the amount they are seeking to recover is not that large. Furthermore, it lacks a certain deterrent effect in that those contemplating fraudulent behaviour will not necessarily know that it is a route that can lead to them, whereas the Insolvency Act clearly and unequivocally states their potential liability.

At this juncture it must be recalled that asset proceeds from both wrongful trading and fraudulent trading actions of either nature are distributed amongst creditors *pari passu* (under either a compensation order or liquidator's damages in cases of the latter⁸). As Keay highlights in his authoritative work, *McPherson's Law of Company Liquidation*, in cases of s.213 fraudulent trading creditors have **no** priority over one another despite an unsuccessful attempt early on⁹ arguing that the creditors specifically defrauded should have their claims discharged first with the recovered assets being placed into a separate account¹⁰. Yet, this has not always been the case because as will be seen in the development of fraudulent trading¹¹ prior to 1985, creditors rather than solely liquidators were previously permitted to bring fraudulent trading actions.

Having stated the nature of the various paths, it might be suggested that this thesis' enquiry into fraudulent trading might be unwise given the lower burden of proof which its statutory neighbour in the Insolvency Act 1986, s.214 wrongful trading, enjoys. Why look at a provision where there is a harder standard to fulfil to hold defendants liable?

⁶ See later discussion of the expanded scope of the concept of directors under s.214 wrongful trading at [1.3.6].

⁷ R. Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell, London 2011), [14-26] [emphasis added].

⁸ The complex issue of confiscation of assets post-conviction for s.993 fraudulent trading will be dealt with later and the difficulty of restraint orders for unsecured creditors will be explained in due course at [4.3.2].

⁹ In *Re William C. Leitch Brothers Ltd (No.2)* [1933] Ch 261.

¹⁰ A. Keay, *McPherson's Law of Company Liquidation* (2nd edn, Sweet & Maxwell, London 2009), [16.025].

¹¹ At [2.3.7].

However, this approach would be misguided for two reasons. The first reason why this thesis is examining fraudulent trading and not other remedies is that the two remedies which provide the closest potentially suitable alternatives are restricted. For the avoidance of confusion these are dealt with separately below and it will be shown that whilst *prima facie* they seem good alternatives, they have neither the range of putative defendants which is one of fraudulent trading's greatest advantages¹² nor its scope.

Secondly, whilst it is worthwhile briefly examining these potential actions, this thesis is not about "potential remedies for creditors"¹³. To undertake such a task would run into several hundred thousand words and is well beyond this thesis' remit. Neither is it just about practical advantages of one versus the other- it is also an academic study, and fraudulent trading is hugely interesting from an academic point of view. Whilst fairly old in the context of a great deal of company law¹⁴, it has morphed and altered. This is especially pronounced since its bifurcation in 1985 into both a civil and criminal wrong.

Its modern criminal law incarnation is a useful and relevant piece of legislation which, it will be argued, protects **potential** creditors with the wrath of the criminal law to a far better extent than the civil law. Its civil provision under s.213 of the Insolvency Act 1986 is very useful in a practical sense in that it has the vast advantage of being able to capture, "any persons who were knowingly parties"¹⁵ to the fraudulent trading- as occurred most notably in *Re Gerald Cooper Chemicals*¹⁶ and *Morris v Bank of India*¹⁷. Yet this utility is marred slightly by jurisprudential concerns.

Furthermore, and far more importantly, fraudulent trading's exceptionally and usefully wide-ranging application under s.993 of the Companies Act 2006 in the criminal law sphere has enabled the concept to flourish and blossom from its roots in enabling creditors to recover assets from the officers of liquidated companies¹⁸. These factors make fraudulent trading of academic interest and it is hoped that this thesis will provide an unprecedented in-depth study of the fraudulent trading provisions.

This chapter is not examining the minutiae of the in-depth problematics with regards to wrongful trading and the tort of deceit for there is a wealth of literature on these as can be gleaned from the

¹² In both civil law and criminal law.

¹³ For an exposition of creditors and their position with regard to insolvency see Keay (n.10), [7.044]-[7.064] and more generally chapter 12.

¹⁴ Originating on the Statute Book as s.75 of the Companies Act 1928. See [2.2.1].

¹⁵ Insolvency Act 1986, s.213(2).

¹⁶ [1978] Ch 262.

¹⁷ [2005] 2 BCLC 328.

¹⁸ Under the Companies Act 1928, s.75.

footnotes below; instead it will argue that s.213 of the Insolvency Act and criminal law fraudulent trading under s.993 of the Companies Act 2006 are worthwhile of both academic study and appraisal because they cast the net of liability much wider, but also more strictly when compared to wrongful trading. As we shall see, the tort of deceit suffers from the problem that it cannot hold third parties liable as easily, as seen in recent caselaw¹⁹, and within the context of fraudulent trading-esque scenarios, is subject to the severe restriction that:

No action shall be brought whereby to charge any person upon or by reason of any representation or assurance made or given concerning or relating to the character, conduct, credit, ability, trade, or dealings of any other person, to the intent or purpose that such other person may obtain credit, money, or goods upon unless such representation or assurance be made in writing, signed by the party to be charged therewith.²⁰

On the other hand, fraudulent trading suffers from none of these problems in both civil and criminal jurisdictions and, given its wide-ranging application, one can see why it is a Crown Prosecution Service favourite for charging suspected business fraudsters²¹.

1.2-The Nature of Fraudulent Trading

1.2.1- Outline

Whilst the substantive elements and composition of fraudulent trading are examined in later chapters²², it is worthwhile emphasising the important nature of what fraudulent trading *prima facie* functions as. Setting aside arguments regarding its prophylactic effect and purposes pertaining to its criminal law provision, the objective of fraudulent trading and indeed the two other remedies highlighted below is to reimburse creditors for their losses suffered at the hands of deviant corporate behaviour.

Note that fraudulent trading is concerned with corporate as opposed to solely directorial behaviour²³. In attempting to retrieve creditors' assets which were gobbled up either during or just

¹⁹ *Stone & Rolls Ltd (in liquidation) v Moore Stephens* [2009] 1 AC 1391.

²⁰ Statute of Frauds Amendment Act 1828, s.6.

²¹ A fact conveyed to me by a number of practitioners including Lord Carlisle Q.C. whose practice includes such cases and whose wife is the D.P.P.'s principal legal advisor.

²² Chapters two and three.

²³ Compare this with wrongful trading at [1.3] and to an extent the tort of deceit at [1.4.2] and [1.4.3] below.

before the liquidation of companies²⁴, it is worthwhile noting that fraudulent trading is a superb shining example of what might be termed “creditor wealth maximisation”.

Creditor wealth maximisation is one of the main, if not the foremost, competing rationales for insolvency law- though the competition between various rationales is hotly debated and contested²⁵.

1.2.2- A brief look at creditor wealth maximisation

Wealth maximisation of creditors, aims to do just that and the father of this approach T.H. Jackson (often joined by D.G. Baird²⁶) succinctly sums up this rationale in his distinguished work *The Logic and Limits of Bankruptcy Law*, in that bankruptcy and insolvency law is a, ‘collectivized debt collection device’²⁷.

Therefore its primary purpose is to enable creditors to collect and recoup, as far as possible, their lent assets. Increasing the creditors’ communal “assets pot” available for distribution to as large amount as is feasible is the aim.

Another function of the “assets pot” is that it prevents the grabbing of assets by individual creditors in a free-for-all. For if individual creditors were simply permitted to recoup assets at will, then more likely than not one or only a handful of powerful or well-resourced creditors would simply recoup all of their assets leaving nothing at all for any other creditors. This is what Jackson identifies as the common pool problem²⁸ using the unique analogy of fishermen (creditors) fishing in a pond (the assets pot) and this is a drawback which the tort of deceit suffers from when contrasted alongside both wrongful and fraudulent trading remedies in this context for these latter remedies have the recovered assets distributed *pari passu*²⁹.

²⁴ Although to launch criminal fraudulent trading under s.993 of the Companies Act 2006, a company does not strictly have to be in liquidation or being liquidated but almost always is as that is the most likely time when the errant behaviour is uncovered.

²⁵ In her superb work on insolvency law, Finch espouses and outlines the half dozen or so models or rationales behind this field of practice- V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP, Cambridge 2009), 32-48. See also J. Armour, ‘The Law and Economics of Corporate Insolvency: A Review’ (2001) ESRC Centre for Business Research, University of Cambridge Working Paper No. 197, 8-14.
<<http://www.cbr.cam.ac.uk/pdf/wp197.pdf> > accessed 18th January 2011.

²⁶ See for example D.G. Baird, ‘The Uneasy Case for Corporate Reorganisations’ (1986) 15 Journal of Legal Studies 127 and D.G. Baird, ‘A World Without Bankruptcy’ (1987) 50 Law and Contemporary Problems 173.

²⁷ T.H. Jackson, *The Logic and Limits of Bankruptcy Law* (Beard Books, Washington D.C. U.S.A. 2001), 7.

²⁸ Ibid, 11-19.

²⁹ Even in the case of creditors post-conviction for criminal fraudulent trading.

The deliberate overriding of individual creditors' selfish urges to seize assets³⁰ means that the overall size of the pot is not diminished (as would occur if tens of sets of legal and administrative costs were applied, rather than one set under a liquidator for example). It is submitted that it also allows the creditor market not to be forced into an oligopoly of one or two very large creditors controlling most of the supply of business credit³¹.

Per Jackson, 'the most obvious reason for a collective system of creditor collection is to make sure that the creditors, in pursuing their individual remedies do not actually decrease the aggregate value of the assets that will be used to repay them.'³²

As Armour eruditely points out³³, there is support in insolvency law on both this and the other side of the Atlantic for the creditor wealth maximisation model. Indeed, reflecting on yet another jurisdiction, as Finch highlights³⁴, Germany's corporate insolvency statute the *Insolvenzordnung*³⁵ is a prime example of an entire system of modern insolvency law which has placed this notion at the centre of their jurisprudence. The *InsO* is very much centred on recovering creditors' assets though it has come under attack for failing, unlike other insolvency regimes, to promote the saving of businesses through restructuring³⁶.

Returning to the common law legal sphere, Armour evinces that the shift of the objects of directors' duties from shareholders to creditors in a firm's so-called "twilight period" provides firm evidence of this creditor wealth maximisation model³⁷. However, it is submitted that it is not this switch of class of persons to whom a director owes his duty *per se* that provides evidence for this rationale of insolvency law. Instead, it is the **consequences** that flow from a breach of such a duty. Namely that, for example under ss.213 and 214, a director can be made personally liable to creditors. This liability will inflate the "assets pot" and thus is clear proof of the substantive element of the Jacksonian model.

³⁰ Jackson (n.27), 128.

³¹ This is perhaps partially echoed in the current political climate where Vince Cable, the Secretary of State for Business, Innovation and Skills, has been leading calls to break up large banks.

³² Jackson (n.27), 14 [emphasis added].

³³ Armour (n.25), 9.

³⁴ Finch (n.25), 33.

³⁵ 1994 Insolvency Statute (*Insolvenzordnung (InsO)*) (Germany).

³⁶ See S. Kalsi, 'German Insolvency: Present Challenges And Potential Solutions' *Financier Worldwide* (Birmingham, March 2008) <http://www.financierworldwide.com/article_printable.php?id=1909> accessed 19th March 2011 and see further, T. Bachner, *Creditor Protection In Private Companies: Anglo-German Perspectives For A European Legal Discourse* (International Corporate Law and Financial Market Regulation Series, CUP, Cambridge 2009).

³⁷ Armour (n.25), 9.

It is not only directors from whom duties towards creditors are owed. Section 213 of the Insolvency Act 1986 enables third parties to be held liable³⁸ as does s.993 of the Companies Act 2006. Furthermore procedurally, during the recovery of assets in this jurisdiction, creditors are also owed duties by liquidators as well³⁹.

What this evinces is that insolvency law has a propensity to ensure that creditors' interests and wealth is both prioritised and well looked after and thus inexorably highlights that the creditor wealth maximisation model substantively has a strong position in insolvency law.

It must also be pointed out that these policy goals and the model itself, even as a normative entity, are not without criticism by authors such as Warren⁴⁰ and Carlson⁴¹. Mokal is the most vocal recent critic in his monograph which examines the Jacksonian model in great detail⁴². Such in-depth consideration of this and other models of insolvency law is not needed here as a solely substantive approach is taken with regards to fraudulent trading. However it is felt necessary to briefly contextualise fraudulent trading within an insolvency law theoretical framework- even if it is one which is moot.

1.3-Wrongful Trading Problematics

1.3.1- Overview

Wrongful trading is constrained to being applied to directors **only** and arguably, this restriction perhaps goes some way in accounting for its lower burden of proof. That is to say that, in terms of a burden of evidence, it is far easier to satisfy but fewer putative defendants come within its permitted remit⁴³.

Fraudulent trading contrarily depends merely upon being party to the mischief and knowingly being so. In practical terms it is mostly directors who are penalised, but this is not always the case and

³⁸ As for example in *Morris v Banque Arabe Internationale d'Investissement SA (No.2)* [2002] BCC 407 and *Morris v Bank of India* [2005] BCC 739, see further [2.3.8].

³⁹ As *per* the Insolvency Act 1986, chapter VII.

⁴⁰ E. Warren, 'Bankruptcy Policy' (1987) 54 University of Chicago Law Review 775.

⁴¹ D.G. Carlson, 'Philosophy In Bankruptcy' (1986-1987) 85 Michigan Law Review 1341.

⁴² R.J. Mokal, *Corporate Insolvency Law: Theory and Application* (OUP, Oxford 2005), 34 and 37.

⁴³ The most recent case where directors of a company, ostensibly in continuous balance sheet insolvency, nonetheless continued to accept credit was brought before the Courts as a wrongful trading action- *Re Idessa (UK) Ltd (In Liquidation)* [2011] EWHC 804 (Ch).

usefully so⁴⁴. Indeed, as Keay points out, whilst there was thought to be an inevitable decline and cessation in the use of s.213 as wrongful trading was introduced, this has not been the case with a smattering of actions in recent times⁴⁵.

It has been recognised in a vast swathe of literature that s.214 suffers from several different problems in terms of *inter alia* procedure, timing of the relevant directorial behaviour being impugned and funding⁴⁶. These concerns have left several commentators wondering whether, 'the law on wrongful trading is little more than a paper tiger.'⁴⁷

It must be conceded that fraudulent trading can suffer from an aspect of this- such as the problematic issue of liquidator funding. Yet, it is framed in much wider terms under s.213 of the Insolvency Act with its ability to hold third parties liable and vastly inflate the "assets pot" of creditors⁴⁸ and so whilst it may be more difficult to succeed, the rewards for doing so may be far larger and the opportunity for bringing actions greater given its wider remit.

It will also be submitted that a lower threshold of liability under wrongful trading is arguably required given the post of director and the rewards and responsibilities it carries with it in the corporate world. Yet to expose third parties to a lower threshold would, it will be contended, dampen commerciality.

1.3.2- The nature of the provisions

Something must be noted of the nature rather than the substance of the two neighbouring provisions in the Insolvency Act 1986 and fraudulent trading's sibling to be found in the Companies Act 2006⁴⁹.

Keay has noted in his enunciation of a convincing theoretical argument against s.214 wrongful trading that under the imposing weight of academic literature, it is assumed to be a normative

⁴⁴ As in where a bank was held liable for knowingly financing B.C.C.I. in its massive fraud on creditors in *Morris v Bank of India* [2005] 2 BCLC 328.

⁴⁵ A. Keay, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish, Abingdon 2007), 65.

⁴⁶ For the delivery of an excellent exposition of these: *ibid*, 131-141.

⁴⁷ C. Cook, 'Wrongful Trading - Is It A Real Threat To Directors Or A Paper Tiger?' [1999] *Insolvency Lawyer* 99, 100. See also A. Keay, 'Wrongful Trading and the Liability of Company Directors : A Theoretical Perspective' (2005) 25 *Legal Studies* 431; S. Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing, Oxford 1999), chapter 4 and P. Godfrey and S. Nield, 'The Wrongful Trading Provisions- All Bark and No Bite' (1995) 11 *Insolvency Law & Practice* 139.

⁴⁸ N.B. this ability has been slightly reduced by *Morphitis v Bernasconi* [2003] Ch 552 which prohibits punitive damages under s.213. Nonetheless its ability to hold banks and other asset-rich third parties liable will enable this inflation to be far more fruitful than under wrongful trading.

⁴⁹ At s.993.

provision⁵⁰; guiding directors' behaviour and supposedly preventing what might be termed casino-style risks being taken to the detriment of creditors. This is certainly true, and it must be argued that s.213 of the Insolvency Act 1986 would also adhere to this as it seeks, on fairly similar terms, to guide and control corporate⁵¹ behaviour. Yet there has been comparatively far less ink spilt over criticism of the fraudulent trading provision given its age and usage.

However, distinctions must be made because the ancestry of the two provisions is entirely different and their nature *per se* rather than their aim is drastically dissimilar it is submitted. Their nature is examined below in this work⁵², yet in being normative and guiding or attempting to guide behaviour, it is argued that the incentive to induce good corporate behaviour must be a strong one.

Both ss.213 and 214 impose unlimited personal liability on those held liable⁵³, yet there is an important distinction which renders fraudulent trading perhaps a more effective normative guide. That is the fact that conceptually its power under s.993 of the Companies Act 2006 is so immense- with a maximum sentence of up to ten years imprisonment⁵⁴. Although there is the obvious procedural barrier of the different burden of proof between civil and criminal law procedures, it is contended that fraudulent trading has a far more persuasive normative effect given the repercussions of failing to adhere to the normative standard of corporate behaviour it sets.

In addressing this, it is countered with the fact that only very recently have punitive damages been prevented from being awarded in s.213 cases⁵⁵ and, this, coupled with the jurisprudential heritage of fraudulent trading⁵⁶ highlights that fraudulent trading in practice, as a conceptual category of proscribed behaviour, acts as a much better prophylactic and normative guide than wrongful trading.

It is simply irrational and unrealistic to think that a director or other putative defendant will stop and consider whether his or her behaviour will be provable on the balance of probabilities or beyond reasonable doubt- thereby determining whether they will be liable criminally or for fraudulent trading criminally or in the civil sense. Instead, it is ostensibly the fear that they may face up to ten years imprisonment for what they are doing or about to do that will put them off acting in a manner with intent to defraud creditors.

⁵⁰ A. Keay, 'Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective' (2005) 25 Legal Studies 431, 432.

⁵¹ N.B.- not simply directors' behaviour.

⁵² Chapters 2 and 3.

⁵³ Under the Insolvency Act 1986, ss.213(2) and 214(1) respectively.

⁵⁴ See [2.2.4].

⁵⁵ *Morphitis v Bernasconi* [2003] Ch 552, 579.

⁵⁶ Upon which chapter two of this thesis is based.

Of further import however is Keay's observation that, 's.214 does not use the words, "wrongful trading;" it is a description that is only employed in the title to the section. The trading that offends against s.214 is, perhaps, better referred to as "irresponsible."' ⁵⁷ This aptly highlights a point which is not readily made in academic literature and that is that the label which is added to a particular cause of action should be seen as part of the punishment or the resultant action taken against the transgressing actor ⁵⁸.

This is perhaps best illustrated with an example. A person convicted of murder will be known as a "murderer". This stigma and socially repulsed label will be with that person forever, long after they are perhaps released on licence. Relating this same principle back to mischief conducted when a company is in the "twilight zone", fraudulent trading (either civil or criminal) contains in **both** its title and under the description of proscribed behaviour the term "fraud". Thus, anyone held liable under either section will be a "fraudster". It is argued that being labelled or described as a "fraudster" will stigmatise any person within the corporate sphere where trustworthiness is extremely important- with clear detrimental effects.

Wrongful trading on the other hand does not carry with it such stigma or labelling. Simply being called a "wrongful" person is, it is strongly contended, neither emotive nor necessarily even blameworthy since we all do things which are wrong. Add to this Keay's observation about irresponsibility and the label still hardly holds much stigma.

It is therefore clear that fraudulent trading, albeit perhaps a slightly rarer occurrence in our courts, is a worthwhile provision to invoke despite having a higher hurdle of "intent to defraud" to make out to ensure success.

1.3.3- The different hurdles

As is discussed much more thoroughly in chapters 2 and 3 ⁵⁹, fraudulent trading of both civil and criminal types employs a test of "intent to defraud". That is to say that for any person to be liable, they must have intended to defraud creditors through the running of a business ⁶⁰.

⁵⁷ Keay (n.50), 432.

⁵⁸ For greater exposition of labelling theory see: D. Matza, *Becoming Deviant* (Prentice Hall, New Jersey U.S.A. 1969), G. Williams, 'Convictions and Fair Labelling' (1983) 42 CLR 85 and D. Downes and P. Rock, *Understanding Deviance: A Guide to the Sociology of Crime and Rule Breaking* (4th edn, OUP, Oxford 2003).

⁵⁹ See [2.3.3] and [3.2] as here we are contrasting civil provisions.

⁶⁰ Insolvency Act 1986, s.213.

This is noted to be jurisprudentially problematic in that it is ostensibly a criminal law standard of liability⁶¹ with a high evidentiary hurdle to jump over if a successful s.213 action is to be brought. It is a subjective hurdle⁶² which the most recent caselaw dealing with this issue, *Morphitis v Bernasconi*⁶³, outlines is not to be read too widely- specifically, the intention to defraud creditors is not synonymous with simply committing a fraud on a creditor⁶⁴. Furthermore, it is based upon deliberate criminal law *Ghosh* dishonesty⁶⁵ yet one which is not based on the hypothetical ordinary person, but one where general standards of honesty may be invoked; simply asking the question whether the defendant has been dishonest or not⁶⁶.

Chapter 3 will provide a full discussion of the detailed elements of this hurdle. However, the point to emphasise for now is simply that it is a hard standard to satisfy- especially when set alongside that for wrongful trading.

In the context of wrongful trading, the exact nature and minute details of the hurdles⁶⁷ are less important for present purposes; with the main contention being that the stark difference between the hurdles for s.213 and s.214 exists.

To find a director (for it **must** be a director) liable under s.214, a liquidator must prove that the director, 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation'⁶⁸. This is calculated according to a dual test which is a mixture of both the objective and subjective as set out in subsection (4) of the wrongful trading provision. The latter test is the director's own, "general knowledge, skill and experience". A director may be saved because of his or her mere inexperience or incompetence, though this is not so under fraudulent trading⁶⁹.

⁶¹ See [3.2] of this thesis.

⁶² Keay (n.45), 134.

⁶³ [2003] Ch 552.

⁶⁴ Ibid, 575-576.

⁶⁵ *R v Grantham* [1984] QB 675, 683 and *Aktieselskabet Dansk Skibsfinansiering v Brothers* [2001] 2 BCLC 324, 334-335 [accepted counsel's argument].

⁶⁶ See further A. Keay, 'Fraudulent Trading: The Intent to Defraud Element' (2006) 35 CLWR 121.

⁶⁷ See A. Hicks and T.E. Cooke, 'Wrongful Trading- Predicting Insolvency' [1993] JBL 338; A. Keay, 'Wrongful Trading and the Point of Liability' (2006) 19 Insolvency Intelligence 132; I.F. Fletcher, *The Law of Insolvency* (3rd edn, Sweet & Maxwell, London 2002), [27-017]-[27-020] and Keay (n.45), 86-93 and 142-145.

⁶⁸ Insolvency Act 1986, s.214(2)(b).

⁶⁹ Keay (n.45), 89. See generally on this hurdle Keay (n.45), 86-93 for an excellent exposition of the current practice and state of the Law.

The former objective element of wrongful trading consists of the same attributes as those being subjectively scrutinised but of what, 'may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company'⁷⁰.

What is therefore clear is that there is a vast gulf between the nature of the impugned behaviour of both wrongful and fraudulent trading provisions. Indeed as an aside, it has been argued that the wrongful trading provision should revert to how it was originally envisaged by the Cork Committee in being fully objective⁷¹ and this only reinforces the notion that wrongful trading cases are easier to make out in terms of the standard to be applied.

1.3.4- Why is it important that this hurdle differential exists?

It has been demonstrated therefore that there is a contrast in the evidential burden upon plaintiffs⁷² between both fraudulent and wrongful trading provisions. Let us now consider why this may exist- something not undertaken in current literature on the two subjects.

The observation must be made that the difference exists due to practical and logical necessity in that as s.213 fraudulent trading potentially captures a much wider class of persons, it requires a higher hurdle. For if it did not do so, then there would be a floodgates effect and the Courts would simply be inundated with far too many cases. However, it is argued that this may only be part of the story. There is also the further possibility that a higher hurdle exists simply on the basis of ordinary principles of fairness and natural justice insofar as it might not be equitable or just to target third parties for their merely negligent or wrongful behaviour. It is submitted that it is reasonable to say that a director should be liable if they have unreasonably failed to spot inevitable insolvency and thereafter failed to take all reasonable steps to protect creditors- thereby effectively imposing on directors an obligation to do these things; however it is not obviously fair to attack non-directors for failing to appreciate a company's inevitable insolvency, or failing to take all reasonable steps to minimise loss to creditors- Why impose these positive duties of action on third parties whose job is not to run the company? It must be noted that the position is different however with fraudulent trading capturing third parties where they must have intended to defraud creditors.

⁷⁰ Section 214(4)(b).

⁷¹ F. Didcote, 'Controlling the Abuse of Limited Liability: The Effectiveness of the Wrongful Trading Provision' (2008) 19 ICCLR 373, 375-376.

⁷² As well as the prosecuting authority in the case of s.993 of the Companies Act 2006.

What is extremely noteworthy at this juncture is that s.214 wrongful trading was originally intended by the Cork Committee to be unrestricted in its potential liability⁷³; it was supposed to echo the class of persons caught under fraudulent trading with, 'a person whether or not he is an officer of the company' being held liable, 'if he *actually knows* [sic] that the company is trading while insolvent or unable to pay its debts as they fall due'⁷⁴. This must be tempered by the further provision *per* the Report to objectively punish officers of the company **only** if they, "ought in all the circumstances' to have known that the trading was wrongful.'⁷⁵ Yet the fact remains that the first element of this proposed dual-headed liability is targeted at anyone.

Indeed, it was only in the very latter stages of the Parliamentary proceedings during the passage of the Insolvency Bill that it was considered inappropriate and to be, 'throwing the net too wide'⁷⁶. The concern was that not only was everyone from a storeman right up to the chief executive potentially liable (again opening up the Courts to a mountain of potential litigation to deal with) but also there were very important commercial concerns⁷⁷.

The commercial implications of enabling non-directors to be caught under this much lower threshold of wrongful trading *prima facie* do not appear too drastic- the odd middle-manager or auditor may perhaps be caught is one's instinctive feeling.

Yet a wider consideration leads inexorably to the conclusion that to too easily allow third parties and non-directors to fall under s.214 wrongful trading would adversely impact upon the lending and paradoxically the availability of credit.

A provision which casts the net of liability wider, at first blush, would ease and allay the concerns of creditors and lower the cost of borrowing from lending institutions. This is because they would be able to more easily recover their losses given the wider class of persons who are exposed from behind the protection of the corporate veil.

However, these lenders and creditors may themselves end up being caught by the provisions because they, through their due diligence and financial monitoring, will have observed and noted their debtor's finances and so potentially have knowledge of when a company is beginning to struggle. This, coupled with a rational fear that the lending of money to ailing firms will make them liable, will put off lenders and drive up the price and lower the availability of credit.

⁷³ Review Committee, *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558, 1982), 400-401.

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*, 401.

⁷⁶ HL Deb 21st March 1985, vol 461, col 745.

⁷⁷ *Ibid* 745-746.

This can be seen when fraudulent trading with its wider range of potential defendant is used for narrow comparison. Unlike s.214, it can be invoked against “any persons”⁷⁸ or “every person”⁷⁹ depending on whether we are dealing with civil or criminal liability respectively.

Taking s.213 fraudulent trading, one of the most recent cases *Morris v Bank of India*⁸⁰ involved the Bank of India being held liable for knowingly being a party to the infamous fraudulent trading of B.C.C.I. and that it was trite law that, “outsiders” may be held liable under s.213⁸¹.

Therefore, transposing the width of this liability to wrongful trading with its far lower evidentiary threshold for finding liability, it is easy to see how credit markets and lenders would be far more reluctant to lend- with dire financial consequences, especially in the current economic climate.

In addition to these concerns with regards to lending and the availability of credit, Lord Marsh in the House of Lords during the Bill’s transition through Parliament expressed reservations about the wide-ranging potential liability and the inappropriateness of, ‘us[ing] a blunderbuss to crack what is a very specific problem.’⁸² This analogy highlights the central issue; liability should not be imposed in a scatter-gun manner with low criteria to meet but instead should be approached with a specific target or set of hurdles which narrows the range of putative defendants so as to prevent adverse commercial consequences and over-zealous liability.

It can therefore be seen that the variation in difficulty of making out a s.213 and s.214 claim under the Insolvency Act 1986 exists for a vitally important reason given the vast difference in the range of potential defendants between the two provisions.

As a corollary, it must therefore be the case that although fraudulent trading is more difficult to make out than wrongful trading, it would be facile to set s.213 of the Insolvency Act 1986 and s.993 of the Companies Act 2006 aside because wrongful trading is easier because it is easier for a good reason- that it is narrower and does not, quite correctly and logically, have the advantage of greater scope which fraudulent trading has.

Furthermore, the two different sets of provisions are importantly not mutually exclusive *per* s.213(8) of the Insolvency Act⁸³. A liquidator can bring proceedings under both as Doyle highlights, ‘where the circumstances of the liquidation suggest that the company's business had been carried on

⁷⁸ Insolvency Act 1986, s.213(2).

⁷⁹ Companies Act 2006, s.993(1).

⁸⁰ [2005] BCC 739.

⁸¹ *Ibid*, 760-762.

⁸² HL Deb 29th January 1985, vol 459, col 612.

⁸³ See also Keay (n.10), [11.063].

unreasonably and with intent to defraud **at separate times** prior to the subsequent winding-up.⁸⁴

The telling part of Doyle's observation is the fact that these two sets of circumstances must be at temporally separate points which brings us onto one of the key differences between the two provisions in terms of timings which is now examined in the following section.

1.3.5- The inherent problems of s.214 wrongful trading

As pointed out from the very outset, this thesis does not concentrate on wrongful trading and as such a detailed analysis or in-depth regurgitation of material will not be carried out because a great deal of ink has already been spilt over this topic⁸⁵. Given that the civil procedure for fraudulent trading under s.213 of the Insolvency Act is analogous to that for wrongful trading, it too suffers from the procedural problems⁸⁶ relating to the discovery of the mischievous behaviour and the funding of actions⁸⁷. Therefore to raise such issues would be fruitless given that they apply equally to both fraudulent and wrongful trading and the plethora of literature has already made them well-documented.

However, the two types of provision do differ markedly in that liquidators under wrongful trading's s.214(2)(b) must identify the point at which the defendant director, 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation'. This as Simmons, a practitioner in this area, evinces, 'may be an extremely difficult task' with a liquidator having to act with extreme care lest the action be dismissed⁸⁸ - as occurred in *Re Sherborne Associates Ltd*⁸⁹.

⁸⁴ L.G. Doyle, 'Anomalies In the Wrongful Trading Provisions' (1992) 13 Company Lawyer 96, 96 [emphasis added].

⁸⁵ For example- V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP, Cambridge 2009), 741-750; A. Keay, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish, Abingdon 2007), chapters 7-10 and 20; L.S. Sealy, 'Personal Liability of Directors and Officers of Insolvency Companies: A Jurisdictional Perspective (England)' in J.S. Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford 1994), 491-498; I.F. Fletcher, *The Law of Insolvency* (4th edn, Sweet & Maxwell, London 2009), [27-017]-[27-025]; A. Keay, 'Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective' (2005) 25 Legal Studies 431; H.C. Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance' (2004) 1 European Company and Financial Law Review 71.

⁸⁶ S. Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing, Oxford 1999), 92-93.

⁸⁷ Keay (n.10), [11.069]; H.C. Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance' (2004) 1 European Company and Financial Law Review 71, 107-113; J. Armour and A. Walters, 'Funding Liquidation: A Functional View' (2006) 122 LQR 295 and M. Simmons, 'Funding Actions in Insolvency' (1995) 8 Insolvency Intelligence 57.

⁸⁸ M. Simmons, 'Wrongful Trading' (2001) 14 Insolvency Intelligence 12, 13.

⁸⁹ [1995] BCC 40.

Indeed, Hirt identifies what he terms the “inherent uncertainty”⁹⁰ of the point in time which is further hampered by the, “elusive and imprecise”⁹¹ element of the latter part of the test [i.e. there being, ‘no reasonable prospect that the company would avoid going into insolvent liquidation’⁹²].

Furthermore Keay has identified that courts tend to take two different and contrasting approaches which he terms as the “restrictive” and “liberal” approaches in his exposition of issues surrounding the establishment of a “point in time” when the director under s.214(2)(b) ‘knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation’⁹³. This uncertainty further serves to reduce the effectiveness of wrongful trading and he concludes that liquidators are faced with the problem that a more conservative estimation of the point in time, whilst enabling a higher chance of success for the liquidator, will reduce the amount of damages⁹⁴.

This necessity of fairly accurately pinpointing the point at which the above circumstances come into play is not only difficult *per se* given the nebulous and inexact nature of the period in question, but it is also extremely debilitating for liquidators. This can be seen through the low number of reported cases which, according to Finch, directly correlates with liquidators’ difficulties in, “identifying the ‘relevant date or time’ when the director should have been aware...”⁹⁵.

Moreover Hicks, in outlining the Courts’ consideration of this issue in the first part of his excellent article on wrongful trading generally, evidences that liquidators are best advised that, ‘a claim may... only be practicable in the more extreme cases of irresponsible trading.’⁹⁶ The reason for this is that only an almost reckless direction from the board followed by rapid loss of creditor assets will not only guarantee the recovery of costs but also satisfy this woolly concept which requires judicial commercial judgement for certain⁹⁷.

The lateness with which it can be used to intervene, (normally far too late to save a company) has also been derided by several commentators and the Company Law Steering Group as Davies points

⁹⁰ See Hirt (n.87), 104-107.

⁹¹ Ibid, 104.

⁹² Insolvency Act 1986, s.214(2)(b).

⁹³ A. Keay, ‘Wrongful Trading and the Point of Liability’ (2006) 19 Insolvency Intelligence 132.

⁹⁴ Ibid, 134.

⁹⁵ Finch (n.85), 700.

⁹⁶ A. Hicks, ‘Advising of Wrongful Trading: Part 1’ (1993) 14 Company Lawyer 16, 18.

⁹⁷ On this point see further M.B. Hemraj, ‘Editorial: The Business Judgment Rule In Corporate Law’ (2004) 15 ICCLR 192 and A. Keay and J. Loughrey, ‘Derivative Proceedings In A Brave New World For Company Management And Shareholders’ (2010) 3 JBL 151, 161-162 (on director’s duties generally); The Honourable Justice Ipp, ‘The Diligent Director’ (1997) 18 Company Lawyer 162 and M.R. Pasban, ‘A Review Of Directors’ Liabilities Of An Insolvent Company In the U.S. and England’ [2001] JBL 33.

out⁹⁸. It is therefore plain to see that the establishment of a “tipping point” is an extremely difficult issue to resolve.

Yet, given the fact that fraudulent trading requires no such point in time to be identified, there is no confusion or uncertainty which is outlined above to contend with and, furthermore, no need for the complex tactical approaches taken by liquidators in pleading their cases which Keay outlines in his excellent article on the matter⁹⁹. The issues highlighted above have no bearing on the finding of an “intent to defraud” and can even be invoked at an earlier stage as long as the company is “in the course of winding up” for civil s.213 liability. Furthermore, there is not even a need for the corporate vehicle to be being wound up under the criminal provision¹⁰⁰.

This is therefore another main factor setting wrongful and fraudulent trading apart. Both the fact that fraudulent trading of both natures has a wide-ranging utility against non-directors and this lack of a need to prove a certain inevitability of insolvency surely ensures that fraudulent trading is *prima facie* worthwhile of consideration in both academic and practical terms.

1.3.6- Shadow and *de facto* directors- widening the path?

It must be conceded that the sharp, bright line drawn between expansive fraudulent trading that covers a broad range of third parties, and narrow wrongful trading restricted to only directors, has been marginally (but I shall argue, only marginally) blurred by the wider definition that has developed of the category of “director” itself. So wrongful trading, whilst targeting only the rather narrow grouping that is the directors of a company, has admittedly been widened to incorporate what might perhaps be termed extended categories of director. These are the “shadow” and the “*de facto*” director. The former is, ‘a person in accordance with whose directions or instructions the directors of the company are accustomed to act’¹⁰¹ and as Finch highlights, this can incorporate legal as well as natural persons- such as a parent company¹⁰².

⁹⁸ P. Davies, ‘Directors’ Creditor-Regarding Duties In Respect of Trading Decisions Taken In The Vicinity of Insolvency’ (2006) 7 European Business Organization Law Review 302, 317-320.

⁹⁹ Keay (n.93), *ibid*.

¹⁰⁰ Companies Act 2006, s.993(2).

¹⁰¹ *Per* the Companies Act 2006, s.251.

¹⁰² Finch (n.85), 590-591. See also *Re Hydrodan (Corby) Ltd* [1994] BCC 161, 164 on this issue.

De facto directors are individuals who, 'perform the functions and exercise the powers of directors but who are not de jure directors, because they have not been appointed correctly, they have ceased to be qualified to act or they have not been appointed at all.'¹⁰³

This widened remit of the definition of what a director is, potentially mitigates the restriction of wrongful trading to directors only in contrast with fraudulent trading. Indeed, in *Re Hydrodan (Corby) Ltd*¹⁰⁴ a wrongful trading case, it was specifically and unequivocally held that both shadow and *de facto* directors would be caught as a director under s.214 of the Insolvency Act 1986¹⁰⁵.

Yet, a perusal of the most recent caselaw and commentary highlights that the Courts have taken a restricted approach and indeed one which has now been significantly muddled in respect of *de facto* directors. This, it is argued, will make liquidators extremely unlikely to bring actions where the actors are in these other categories of director for the added layer of uncertainty will make them very wary indeed.

De facto directors

Before looking at what these characteristics are, we must turn first to the very recent decision of the Supreme Court reached by a bare majority of 3-2 in *Commissioners for HM Revenue & Customs v Holland ; Paycheck Services 3 Ltd*¹⁰⁶. Both Sealy¹⁰⁷ and Griffin¹⁰⁸ have noted the great deal of confusion and uncertainty which the Lordships' judgements and especially the *obiter dicta* in the case have given rise to. This concentrates on what a *de facto* director is¹⁰⁹ because following this case now no single test nor set battery of factors can be applied as Lowry demonstrates¹¹⁰. Indeed, the majority's finding that, 'So long as the relevant acts are done by the individual entirely within the ambit of the discharge of his duties and responsibilities as a director... it is to that capacity that his acts must be attributed'¹¹¹ is wildly nebulous and difficult to pin down. What are the relevant acts in

¹⁰³ This comprehensive definition is taken from a superb exposition of the development and concept of *de facto* directors- C. Noonan and S. Watson, 'Examining Company Directors Through The Lens of *de facto* Directorship' [2008] JBL 587, 588.

¹⁰⁴ [1994] BCC 161.

¹⁰⁵ *Ibid*, 162.

¹⁰⁶ [2011] BCC 1.

¹⁰⁷ L. Sealy, 'Case Comment: *Paycheck Services 3 Ltd*: the Supreme Court Reviews the Concept of the *de facto* Director' (2011) 287 Company Law Newsletter 1.

¹⁰⁸ S. Griffin, 'Confusion Surrounding the Characteristics, Identification and Liability Of A Shadow Director' [2011] Insolvency Intelligence 44.

¹⁰⁹ Sealy (n.107), 2-3. See also M. Stanley, 'Corporate Directors and *de facto* Directorship- the Supreme Court Requires "something more"' (2011) 4 Corporate Rescue & Insolvency 53.

¹¹⁰ A. Lowry, 'De facto Directorships: Multiple Tests Prevail' (2011) 8 International Corporate Rescue 194.

¹¹¹ (n.106), 20.

the discharging of a director's responsibilities? Within this same paragraph, Lord Hope tentatively postulates that Parliament may want to intervene and flesh out what the factors for *de facto* directorship actually are.

Lord Collins on the other hand, still in the majority, seemed to strongly link the question of *de facto* directorship to the principle in which it, 'is not simply a matter of appreciation of the facts, namely whether what Mr. Holland did in fact was sufficient to make him a *de facto* director of the composite companies, but a question of law and a question of principle.'¹¹² Yet what principles judges will apply in the future is highly moot given the sharp division of the Supreme Court.

Moreover, this has not been the first instance where fuzzy concepts have been applied to *de facto* directorship. For example in *Re Kaytech International PLC*¹¹³ it was held that the defendant was in fact a *de facto* director as he was the, 'moving spirit in giving instructions'¹¹⁴. Though what a "moving spirit" actually is is far less clear.

The mainstay of factors previously cited for determining *de facto* liability are perhaps enunciated best in *Re Gemma Ltd*¹¹⁵. Yet in having regard to the authoritative list of factors which the deputy judge of the High Court considered, it is easy to see that they are fairly restrictive. One cannot be a *de facto* director simply by calling oneself so- it is one's actions and not title that are important¹¹⁶.

The *ratio* of *Secretary of State for Trade and Industry v Hollier*¹¹⁷ was also specifically approved in that access to company information was to be a crucial factor as was being part of the corporate governance apparatus.

Furthermore, relationships with *de jure* directors, especially if they were members of the same family, was an important indication and finally Etherton J in *Hollier* held that the degree of financial interest of the putative *de facto* director was also important¹¹⁸.

In the Court of Appeal's decision in *Commissioners for HM Revenue & Customs v Holland ; Paycheck Services 3 Ltd*¹¹⁹ one of the findings which was not reversed by the Supreme Court was that a lack of decision-making ability prevented a finding of *de facto* directorship. In this case, a clerical role and the signing of cheques was insufficient to be a *de facto* director.

¹¹² (n.106), 22.

¹¹³ [1999] BCC 390.

¹¹⁴ *Ibid*, 401.

¹¹⁵ [2008] BCC 812.

¹¹⁶ *Ibid*, 813.

¹¹⁷ [2007] BCC 11.

¹¹⁸ *Ibid*.

¹¹⁹ [2009] BCC 37.

What the above selection of factors shows is that the Courts have been really rather restrictive in their approach to *de facto* directorship and indeed, even in the controversial *Holland* case, the majority (only just) managed to hold that Mr. Holland was **not** a *de facto* director having applied a factual and principle-based approach.

This restrictive and rather conservative approach therefore tempers to a great degree any gain that wrongful trading liability may purportedly have made by expanding its boundaries beyond merely *de jure* directors.

Shadow directors

The issue of shadow directorship was only fairly recently first considered by the Courts in *Secretary of State for Trade and Industry v Deverell*¹²⁰ which, as Payne highlights¹²¹, widened the net of liability through holding that a malleable and flexible test was to be applied to determine shadow directorship. This in part was to be dependent upon the circumstances of the proceedings and, again, shows the uncertainty and nebulous nature of the concept of directorship.

Yet for present purposes, perhaps the most relevant restriction on the finding of shadow directorship was that espoused in *Ultraframe (UK) Ltd v Fielding*¹²² where conduct which was forced as a result of a financial lending arrangement or transaction was held not to constitute the behaviour of shadow directorship.

Also as Prentice and Payne point out in their in-depth analysis of the case¹²³, Lewison J further held that there can be no retrospective effect in relation to shadow directorship- narrowing further the remit of the scope of who a director is or could potentially be.

Highlighting the extremely close nexus of factors against which both putative shadow and *de facto* directors are judged, Evans-Lombe J in *Secretary of State for Trade and Industry v Hall*¹²⁴, applying *Re Hydrodan* and finding the defendant was not a shadow director, held that positive action was also required for a party to be a shadow director. They must have an active involvement, such as giving instructions, rather than just a passive interest.

¹²⁰ [2001] Ch 340.

¹²¹ J. Payne, 'Casting Light Into the Shadows: *Secretary of State for Trade and Industry v. Deverell*' (2001) 22 Company Lawyer 90.

¹²² [2005] EWHC 1638 (Ch), [296]-[297].

¹²³ D.D. Prentice and J. Payne, 'Case Comment: Directors' Fiduciary Duties' (2006) 122 LQR 558, 561.

¹²⁴ [2009] BCC 190.

Indeed, as the caselaw has continued to develop the statutory definition Parliament provided¹²⁵, the embellishment of *Deverell*, as *Palmer's Company Law* usefully evinces¹²⁶, is then greatly narrowed in that there cannot be simply one act or one *de jure* director who performs the act(s) on behalf of the putative shadow director. Instead, *per* Harman J in *Re Unisoft Group Ltd (No. 2)*¹²⁷, the entire board or at least the governing majority must act in concert on behalf of an outsider for him then to be considered a shadow director.

Does this apply to situations which fill the void between fraudulent trading and s.214?

As noted by the various learned analyses, there has been a great erosion of the distinction between a shadow and *de facto* director which has been brought to a head following *Commissioners for HM Revenue & Customs v Holland; Paycheck Services 3 Ltd*. Griffin highlights that:

the definitions attributed to a *de facto* director and shadow director share an underlying and fundamental characteristic: to establish either of the positions, a person must have the capacity to **exert real influence in the management of a company's affairs**.¹²⁸

The practitioners' bible, *Palmer's Company Law*, regarding the potential fusion of the two concepts of *de facto* and shadow directorship remarks that, 'The overall question is whether the individual in question has assumed **the status and functions of a company director** so as to make himself responsible under CA 2006 as if he were a *de jure* director.'¹²⁹

Whilst whether this has actually occurred is beyond this thesis and is a question left open for company law academics to debate at length, the remarks about the shared characteristics are helpful to us here in the current context.

The key cases are *Re Gerald Cooper Chemicals*¹³⁰, where perhaps one of the most useful features of fraudulent trading in being able to capture third parties was highlighted first, and *Bank of India v Morris*¹³¹. These both keenly highlight the width of fraudulent trading (under s.213) in contrast to wrongful trading. In *Re Gerald Cooper Chemicals* a business lent the company Gerald Cooper Chemicals £150,000 which shortly after became insolvent. Gerald Cooper Chemicals, despite being

¹²⁵ Insolvency Act 1986, s.251.

¹²⁶ G. Morse (ed), *Palmer's Company Law* (Looseleaf Sweet & Maxwell, London), [8.216].

¹²⁷ [1994] BCC 766.

¹²⁸ Griffin (n.108), 45 [emphasis added].

¹²⁹ (n.126), [8.225] [my own emphasis].

¹³⁰ [1978] Ch 262.

¹³¹ [2005] BCC 739.

insolvent, then invited and received advanced payment for goods which it never produced or intended to produce from a different company- now a trade creditor. Using this advance, the chemicals firm paid off £110,000 of the £150,000 owing to the initial lender. Fraudulent trading enabled the trade creditor (as this was prior to the requirement that actions must be brought via the liquidator¹³²) to bring litigation against the firm Gerald Cooper Chemicals as opposed to a director.

In the most recent case, the Bank of India was held liable on the basis it was knowingly a party to the infamous fraudulent trading of B.C.C.I.. Furthermore, it was held by the Court of Appeal that “outsider” companies could be liable under s.213 fraudulent trading¹³³ and that specifically and crucially, ‘It was not the policy of Parliament in that section to make “outsider” individuals and companies liable for wrongful trading.’¹³⁴

It is clear from Mummery LJ’s *dicta* that “outsiders” such as banks or major creditors come within fraudulent but **not** within wrongful trading’s scope. Furthermore, the unsuccessful appellant in *Bank of India v Morris* comes nowhere near fitting the description commentators make about the general features and nature of shadow and *de facto* directorship. A bank or creditor certainly does not assume the features emboldened in the two quotes above. They certainly neither manage the company nor in almost all cases take the everyday responsibility or remuneration that a director (of any description) would.

Does shadow or *de facto* directorship plug the wide hole in s.214’s narrow remit?

The answer is plainly no. Overall it is strongly contended that despite wrongful trading’s ability to increase its scope of liability beyond a *de jure* director, it **still** does not encompass the width of putative defendants that fraudulent trading does. This is for the simple reason that the width of fraudulent trading’s “any persons who were knowingly parties” goes beyond directorship (in any sense). This is supported strongly by two means. Firstly, the strict narrow reading of both *de facto* and shadow director directorship, as demonstrated above, does **not** expand s.214 wrongful trading much further beyond the standard *de jure* director. Secondly, as perhaps a slightly less noticeable but nevertheless illuminating observation, comments on the potential blurring of the different sorts of directorship do not reveal situations in which the wide remit of fraudulent trading can be matched by wrongful trading’s and rightly so, as *per* my earlier contention.

¹³² Brought in by the Insolvency Act 1986, s.213. See further [2.2.1] and [2.3.7].

¹³³ (n.131), 761.

¹³⁴ (n.131), 762.

1.4-Tort of Deceit Problematics

1.4.1- Overview

As a secondary potentially viable alternative to an action for fraudulent trading, though one which is rather infrequent, Jones highlights that for creditors blinkeredly set upon recovering their assets there is the possibility of bringing an action for the tort of deceit¹³⁵. Naturally, it has the perceived advantage of not requiring a liquidator to take the action on their behalf (nor the Crown Prosecution Service in the case of criminal fraudulent trading). It could therefore be used by a creditor where they are large and powerful enough to go it alone and the liquidator is unprepared or unwilling to risk the “assets pot”. Though whether as a policy within an insolvency context this is desirable, is questionable.

It is furthermore conceded that the tort of deceit also carries with it the stigma of a finding of deliberate deception and of a fraudulent mindset¹³⁶, rather than incompetence or carelessness¹³⁷ against those held liable.

The five elements to establish the tort are succinctly and aptly set out in that well-established favourite of Law students and scholars *Winfield and Jolowicz On Tort*, and are as follows:

- A representation of fact (by either words or conduct)
- This must be made knowing it is false; either wilfully or in the absence of genuine belief in its truth
- It must be intended that the claimant acts upon the representation
- The fact that the claimant did act upon the representation must be proved
- It must be proved the claimant suffered damage arising from his action¹³⁸

1.4.2- Difficulties with deceit

Immediately it can be seen that there are several hurdles over which a putative claimant must jump and each has their own perils which must be overcome¹³⁹.

¹³⁵ B. Jones, ‘Case Comment: The Difficulty of Proving Fraudulent Trading’ [2003] *Insolvency Intelligence* 69, 70.

¹³⁶ See for example, *Stone & Rolls Ltd (In Liquidation) v Moore Stephens* [2009] 1 AC 1391.

¹³⁷ As in wrongful trading under the Insolvency Act 1986, s.214.

¹³⁸ W.V.H. Rogers, *Winfield and Jolowicz On Tort* (18th edn, Sweet & Maxwell 2010), [11-3]. See further A.M. Dugdale *et alii* (eds), *Clerk & Lindsell On Torts* (Common Law Library Series, 19th edn, Sweet & Maxwell, London 2006), chapter 18.

This multilayered liability combined with the fact that it is a common law action, it is argued, makes for a much-diminished prophylactic effect upon directors' and other parties' behaviour. Clarity and certainty are all-important in the commercial arena as can be highlighted by the fact that directors' duties are now codified in the Companies Act 2006¹⁴⁰ rather than being in their former disparate body of caselaw. Therefore in contrast to the firmly set-out provisions of fraudulent trading under either the Insolvency or Companies Acts, the tort of deceit does not have the same preventative effect. A person would have to seek legal advice or perhaps obtain his own copy of *Winfield and Jolowicz On Tort* to realise the true extent of his potential liability.

Furthermore, Goode tellingly highlights in his tentative suggestion of deceit as an alternative remedy to fraudulent trading that there may be a possibility of, 'an action for deceit, as where the **director** obtains goods or services for the company by making an express or implied representation **in writing** that the company is solvent.'¹⁴¹ The tort of deceit enables creditors, if they succeed, to gain proceeds for themselves rather than being included in the general pot of company assets as Milman evinces¹⁴².

Yet, in dealing with the first of these emboldened elements, it must be pointed out that unlike in fraudulent trading, as will be seen fully in a later chapter¹⁴³, deceit only captures narrowly the person who made the deceitful representations. Invariably this is the director or the company on behalf of which he made the representation¹⁴⁴. Going after the company is fruitless in an insolvency-based situation in which the tort of deceit could be an alternative to fraudulent trading and a director is also likely to have limited assets in comparison to a third party company.

There have been recent attempts in the case of *Stone & Rolls Ltd (in liquidation) v Moore Stephens*¹⁴⁵ to encapsulate third parties within the tort who may have contributed to defrauding creditors. In this case it was in failing to notice flagrantly fraudulent activity. However this was dismissed by a bare majority in the House of Lords on very technical public policy arguments. It is noteworthy as the case aptly highlights the problem with deceit in that creditor affected, a Czech bank, obtained deceit damages against both the director who carried out the fraudulent behaviour and the company-forcing it into liquidation.

¹³⁹ Ibid, [11-4]-[11-15].

¹⁴⁰ Under ss. 170-177.

¹⁴¹ Goode (n.7), [14-26] [my own emphasis].

¹⁴² D. Milman, 'Case Comment: Two Cases of Interest For Company Directors Operating In The Twilight Zone' [2008] Insolvency Intelligence 25, 26.

¹⁴³ [2.3.7].

¹⁴⁴ For example as in *Sean Lindsay v Jared O'Loughnane* [2010] EWHC 529 (QB) and *Contex Drouzhba Ltd v Wiseman* [2008] BCC 301.

¹⁴⁵ [2009] 1 AC 1391.

It was **then** up to the company (now in liquidation following its payout to the Czech bank creditor) to attempt to bring this secondary action and this failure leaves the rest of the entire body of creditors out of pocket. If the company had previously been in liquidation- as occurs in s.213 and s.214 scenarios, the Czech bank would not have been able to bring an action against the auditors who failed to notice the fraud, nor force Stone Rolls Ltd to do so.

This privity-esque principle in that the auditor although being a large part of the company Stone Rolls' deceit, despite very narrowly but successfully raising a defence, cannot be held accountable by the deceived creditor is a major disadvantage.

If neither the director nor the company had any realisable assets, then the Czech bank would have been totally fruitless in terms of an action in deceit and most likely would not even have been able to recover lost legal and administrative fees incurred in pursuing the action.

1.4.3- The need for writing

There is also the problem of representations having to be made "in writing". This is due to an old statutory restriction¹⁴⁶ as outlined in full above¹⁴⁷ imposed under the Statute of Frauds Amendment Act 1828 (otherwise known as Lord Tenterden's Act).

Though it is important to note that this relates to representations as to *inter alia* credit which was the primary purpose of the passing of the Act, as Rogers makes clear¹⁴⁸. It forces representations regarding creditworthiness to be written and signed by the charge-bearing party. It is this situation which is identical to that in which fraudulent (and indeed wrongful) trading can arise; a director or party will provide representations (written or otherwise) as to the creditworthiness of a company.

In the fairly recent case of *Contex Drouzhba v Wiseman*¹⁴⁹ the Act was further restricted in that a director's signature on the written representation would **not** be adequate to hold him personally liable in deceit¹⁵⁰. The Court of Appeal also dealt with the question of the effect of deceit with regards to liability under ss.213 and/or 214 of the Insolvency Act 1986. In holding that actions for deceit against directors can occur notwithstanding liability under the Insolvency Act, their Lordships through Waller LJ, made some interesting and highly pertinent comments.

¹⁴⁶ (n.20), *ibid*.

¹⁴⁷ [1.1].

¹⁴⁸ Rogers (n.138), [11-32].

¹⁴⁹ [2008] BCC 301.

¹⁵⁰ *Ibid*, 305. See also — —, 'Case Comment: *Contex Drouzhba Ltd v Wiseman*: Director Liable For Implied Representation of Company's Ability To Pay' (2008) 234 Company Law Newsletter 6.

First, they noted that there has been a dearth of deceit cases and within the same paragraph highlight, 'the fact that there is legislation dealing with fraudulent trading (ss.213 and **214** of the Insolvency Act 1986) by virtue of which... **fraudulent directors** can be made liable for the deception perpetrated on creditors'¹⁵¹. The first of their points is clear to heed, though their comments through the mouthpiece of Waller LJ are extremely revealing- even if written subconsciously.

The words in bold expose the fact that s.214 wrongful trading is used as a viable alternative to s.213 in holding fraudulent **directors** liable. Why realistically would liquidators ever opt for a higher evidentiary hurdle to jump under s.213 when the same end result can be achieved with wrongful trading in holding directors liable?

The key here however is directors and directors only are able to be caught under the wrongful trading provisions.

Ulph also evinces that there is a great deal of difficulty in proving a claim in deceit¹⁵² which correlates with Waller LJ's comments about a general lack of actions in the tort of deceit, above. She also postulates that plaintiffs are more often driven to equity-based remedies such as a breach of duty (though now almost exclusively codified in statute¹⁵³) due to the difficulties of proof for torts generally and also the problematics of recovery for economic loss.

One final point must be made with regards to deceit for it feeds into later arguments regarding the efficacy of fraudulent trading¹⁵⁴. Zhou notes in his economic analysis of deceit that the plaintiff is sometimes awarded compensation over-and-above his actual loss which contrasts with non-fraudulent misrepresentation¹⁵⁵. Economically this is justified as a more effective deterrent for fraudulent behaviour which, *per se*, is much more reprehensible than other misrepresentations.

Overall therefore, it has been demonstrated that whilst the tort of deceit may enable individual creditors to circumvent the usual rules regarding requiring the liquidator to bring proceedings, they

¹⁵¹ (n.149), 303 [emphasis added].

¹⁵² J. Ulph, *Commercial Fraud: Civil Liability, Human Rights, and Money Laundering* (OUP, Oxford 2006), 236.

¹⁵³ Companies Act 2006, ss. 170-177. Though see also Keay's eminent work on directors' duties towards creditors- A. Keay, 'Formulating a Framework For Directors' Duties to Creditors: An Entity Maximisation Approach' (2005) 64 CLJ 614, 614, 'There has been no unanimous judicial pronouncement'; A. Keay, 'The Duty of Directors to Take Into Account Creditors' Interests; Has it Any Role To Play?' [2002] JBL 379; A. Keay, 'The Director's Duty to Take Into Account the Interests of Company Creditors: When Is It Triggered?' (2001) 25 Melbourne University Law Review 315; A. Keay, 'Another Way of Skinning A Cat: Enforcing Directors' Duties For the Benefit of Creditors' (2004) 17 Insolvency Intelligence 1; A. Keay, 'A Theoretical Analysis of the Director's Duty To Consider Creditor Interests: The Progressive School's Approach' (2004) 4 Journal of Corporate Law Studies 307 and A. Keay, 'Directors Taking Into Account Creditor Interests' (2003) 24 Company Lawyer 300.

¹⁵⁴ Dealt with at [3.4].

¹⁵⁵ Q. Zhou, 'Economic Analysis of the Legal Standard For Deceit In English Tort Law' (2009) 28 European Journal of Law & Economics 83, 88.

may only do so when the fraudulent representation to them is a written one. Whilst not the foremost limitation of the tort, it is contended that it is nonetheless an important one. Assurances to banks and other creditors who chase up their credit from the small and medium-sized companies which make up the preponderance of the corporate landscape are unlikely to always be in writing. This is especially the case if pragmatically the company is not faring well and management begins to fall into disarray.

Another troubling element of the entire notion of an action in deceit which may easily be overlooked is the potential inequity which could be caused— something which Keay is quick to praise with regards to s.213 Insolvency Act fraudulent trading provisions and its *pari passu* distribution of assets¹⁵⁶. A sole powerful and well-resourced creditor could, with a successful action in deceit, remove all or nearly all of the liquidated company's assets in one fell swoop. This would then leave absolutely nothing or hardly anything for unsecured creditors who are likely to be those least economically able to suffer losses¹⁵⁷.

Yet overall the most problematic element of the tort of deceit when brought alongside fraudulent trading is that it fails to encapsulate parties who may have directly contributed to the deceitful action. Fraudulent trading however captures “any persons who were knowingly parties” to the impugned behaviour and this wide-scoped element it is argued acts as an important and effective deterrent to prevent such third party behaviour occurring.

1.5-Conclusion

This chapter has shown that fraudulent trading, despite having a purportedly higher threshold to meet in terms of successfully making out a case, is worthy not only of study but also scrutiny. It has been highlighted that, beyond whatever academic interest there may remain in the philosophy of provisions targeting fraud on creditors, these provisions are likely to have a continuing practical significance. In particular they are not rendered practically irrelevant or redundant by alternative actions under s.214 wrongful trading or for the tort of deceit.

¹⁵⁶ Keay (n.10), [16.023].

¹⁵⁷ Precisely the “common pool problem” outlined by Jackson. See [1.2.2] above.

It would be short-sighted and superficial to ignore fraudulent trading on the grounds that s.214 is easier to make out as a cause of action because this ignores the fact that it is not necessarily easier in practical and commercial terms to bring such an action; this is especially so given the much narrower class of persons against whom actions may be brought under s.214 for wrongful trading.

Furthermore, whilst actions under the tort of deceit have been postulated by a few commentators as an alternative, they too suffer drawbacks relating to the class of putative defendants as well as the restriction that only written misrepresentations are actionable.

Bringing s.993 of the Companies Act 2006 criminal law fraudulent trading into play, whilst wrongful trading, 'sets a **commercially** moral standard of conduct'¹⁵⁸ as Simmons highlights, it is submitted that the proscription of morally abhorrent conduct (either due to commercial considerations or *per se*) is best dealt with by the criminal law. This theme, especially surrounding the language of fraudulent trading's "intent to defraud" will be a continuing one throughout this thesis. It is hoped that now the value and utility of scrutinising fraudulent trading will be seen without recourse to what might previously be cynically termed an elephant in the room.

Not only has the elephant been led away, but also it might rightfully be described as having been stunned given the weight of academic literature arguing against the effectiveness and scope of fraudulent trading alternatives and this would perhaps be worthy of further exploration were it not for space constraints and the sheer vast volume of published work already in the academic domain.

The next chapter looks at how fraudulent trading has developed since its inception in 1926 for it has changed and transformed from one overarching concept into two separate provisions which have each headed in their own separate directions of the Law. From closely examining the history of fraudulent trading, different relevant ideas and points of note can be made which feed into analyses undertaken later on in this thesis.

¹⁵⁸ *Per* Simmons (n.88), 13 [emphasis added].

Chapter Two:

The Development of Fraudulent Trading- A Mixed Bag

2.1-Outline

Having established that fraudulent trading is conceptually and academically worthwhile of examination, this chapter will trace its development for it has not always been two separate provisions in criminal and civil law.

The dual provisions for the wrong of fraudulent trading have been described as, '[t]he most important statutory incursion into the principle of the separate personality of a company'¹. Such a comment must not be lightly overlooked in that this is one of the very few exceptions in company law to the foundational principle of corporate personality which has been sacrosanct since *Salomon v Salomon*².

However, before dealing with the two forms of this provision in isolation, this chapter will examine the jurisprudential heritage which the modern civil provision for fraudulent trading under s.213 of the Insolvency Act 1986 shares with its criminal law legal sibling- s.993 of the Companies Act 2006. This will form the foundation for later arguments that s.213 civil fraudulent trading has been heavily influenced by an influx of criminal law jurisprudence to be at best handicapped practically, and at worst jurisprudentially unacceptable.

It must be borne in mind that the two were separated only as recently as 1985 when the civil provision was moved into an entirely new section of the Companies Act³ away from criminal fraudulent trading⁴ before being re-enacted into its present position on the Statute Book in 1986.

It is intended that both s.993 of the Companies Act 2006 and s.213 of the Insolvency Act will be thoroughly examined. These are not only worthy of scrutiny as a means of piercing the corporate veil *per se*, they are also useful tools in the armoury of both creditors in trying to recoup their losses when companies become insolvent and as a deterrent for deviant behaviour.

¹ R.C. Williams, 'Fraudulent Trading' (1986) 4 Company & Securities Law Journal 14, 14.

² [1897] AC 22. See further D. Ohrenstein, 'The Lifted Veil' (2010) 32 Commercial Litigation Journal 18.

³ Companies Act 1985, s.630.

⁴ Which was found at Companies Act 1985, s.458.

Importantly, it should also be noted that the s.213 fraudulent trading provision, in contrast to s.993, may only be used when insolvent companies are liquidated as the provision applies only to proscribed behaviour which is discovered, “in the course of the winding up of a company”⁵. The actual activity constituting fraudulent trading however can occur before or during the period of winding up. This prerequisite of insolvency will be discussed below as it gives rise to important issues surrounding what the purpose of s.213 is and its utility relative to s.993⁶.

The structure of the chapter is as follows. First the history and circumstances surrounding the enactment of the fraudulent trading provisions will be evinced as this is essential for a full and rounded understanding of the arguments to be set out in due course.

Then the post-1985 split caselaw will be examined whereby it will be pointed out that it still is firmly anchored in the dual-provision jurisprudence which, it will be contended, is inappropriate.

2.2-Historical Beginnings

2.2.1-Development

Both sections 993 of the Companies Act and 213 of the Insolvency Act took some 60 years to reach their present form and began life as a single unified fraudulent trading provision spawned from a recommendation made by the Greene Committee of 1926⁷. The Committee identified that something needed to be done about those holding floating charges in control of companies who, when their companies were on the verge of liquidation, ‘fills up his security by means of goods obtained on credit and then appoints a receiver.’⁸ To clarify, this “security” refers to credit arrangements whereby directors give personal guarantees to creditors which, as Ryan evinces⁹, is a common practice- especially in private companies. By “filling up his own security” with other creditors’ assets, those running companies could then do one of two undesirable things. They could either deflect their own personal liability on to other creditors by first paying off the creditor(s)

⁵ Insolvency Act 1986, s.213(1).

⁶ See [3.3] below.

⁷ Company Law Amendment Committee, *1925-1925 Report* (Cmd 2657, 1926), 28-30.

⁸ *Ibid*, 28.

⁹ C. Ryan, *Company Directors: Liabilities, Rights and Duties* (3rd edn, CCH Editions Limited, Bicester 1990), 224.

threatening to invoke his personal guarantee¹⁰. Or alternatively, they could ensure that that creditor will be paid off first in preference to all others in the winding up of the company.

The Greene Committee felt that the Law surrounding creditors' floating charges over assets was too important and too essential in corporate finance to be altered¹¹. It was instead suggested that those found to have committed fraudulent trading should no longer be able to hide behind the corporate veil and limit their own liability. Instead, they were to be subject to unlimited personal liability and any assets that the rogue held or disposed of should be charged with his outstanding liability.

There are two interesting points of note. Firstly, the Committee's recommendation was that this asset recovery should apply to those, 'whom the Court finds to have been guilty of fraudulent trading'¹². The fact that the word "guilty" was used is noteworthy; even though the remedy appeared to be civil in nature in that it allowed the recovery of assets. There are therefore definite overtones of criminality springing from the Committee's recommendations- even though they *prima facie* deal with only civil liability.

Secondly, the Report in the very next sentence provides **furthermore** for a criminal offence; 'Further, trading of this character should be made a criminal offence'¹³. Whilst, as Farrar highlights, there are two heads of liability- one criminal as well as one allowing civil recovery right from the outset of statutory fraudulent trading¹⁴, it is submitted that the Committee subtly blended the two. Whether this was a semantic oversight or simply jurisprudential foresight of today's situation where prosecutions are brought under s.993 of the Companies Act 2006 and then assets can be potentially recovered under the Proceeds of Crime Act 2002 process and/or compensation orders¹⁵, is moot.

Subsequently, Parliament enacted the Committee's recommendations in s.75 of the Companies Act 1928 which placed all-too-familiar language on the Statute Book prohibiting, 'any business of the company' being 'carried on with intent to defraud creditors'¹⁶. Section 75 however was more widely framed than its civil descendant s.213 of the Insolvency Act 1986 in that it permitted not only liquidators¹⁷ but also creditors and those who had contributed to the company to gain recourse

¹⁰ N.B.- this practice is no longer permitted under s.245 of the Insolvency Act as Finch points out in V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP, Cambridge 2009), 696.

¹¹ Company Law Amendment Committee (n.7), 28.

¹² Company Law Amendment Committee (n.7), 28-29.

¹³ Company Law Amendment Committee (n.7), 29.

¹⁴ J.H. Farrar, 'Fraudulent Trading' [1980] JBL 336, 336.

¹⁵ Examined later at [4.3.2].

¹⁶ Companies Act 1928, s.75(1). See also Appendix 1, p.109 below.

¹⁷ For the avoidance of doubt, throughout this thesis the word "liquidator" is to specifically exclude the Official Receiver as different rules usually apply. The Official Receiver is also normally only appointed on a provisional basis until another insolvency professional is appointed.

against directors and directors only. As will be seen, fraudulent trading was restricted to being used against solely directors until 1947.

Also of note is that s.75(3) which was the subsection providing for criminal fraudulent trading made the offence indictable only. Today it is triable either way as a summary or indictable offence¹⁸.

However the maximum sentence available under s.75(3) was only one year.

The section also provided for a disqualification regime for delinquent directors in that it furnished the Courts with the power to disqualify directors for up to five years¹⁹. Furthermore, s.77(2) of the Act placed a duty upon liquidators to report to the Director of Public Prosecutions any criminal offence (including fraudulent trading) that was uncovered. Both these provisions as well as the tone of the legislation, it is submitted, are a marked departure from the previous *laissez-faire* approach that could be adopted when companies were wound up.

These sections were then re-enacted as they appeared before in a consolidating Act the next year to become s.275 of the Companies Act 1929 and some of the first reported cases began to be brought before the Courts. One of the first, *Re William C. Leitch Brothers Ltd*²⁰ highlighted the difficulties which the provision did, and still does, encounter surrounding the correct meaning and interpretation attributed to the phrase, “carrying on business with intent to defraud creditors”²¹. The legal issues arising in *Re Patrick and Lyon Ltd*²² did not stray too far from the meaning to be attributed to “intent to defraud” either- it was held that to “defraud” connotes, ‘actual dishonesty involving...real moral blame’²³. These two important cases are analysed in greater detail below²⁴.

In 1945 the Cohen Committee in its report²⁵ failed to address or narrow down any meaning for the troublesome phrase. Instead, it recommended the doubling of the maximum sentence to two years for those convicted of the criminal offence of fraudulent trading and also extending the remit of the fraudulent trading provisions in general so as to encompass a much wider group of other officers involved in running companies- not just directors as under the s.275 Companies Act 1929²⁶.

¹⁸ Under the Companies Act 2006, s.993.

¹⁹ Companies Act 1928, s.75(4). Appendix 1, p.109 below.

²⁰ [1932] 2 Ch 71.

²¹ See A. Keay, ‘Fraudulent Trading: The Intent to Defraud Element’ (2006) 35 CLWR 121.

²² [1933] Ch 786.

²³ Ibid, 790.

²⁴ At [2.3.3].

²⁵ Company Law Amendment Committee, *The Report of the Committee of Company Law Amendment* (Cmd 6659, 1945).

²⁶ Ibid, 93.

The Committee's recommendations led, in much the same way as the Greene Committee's report, to new provisions being enacted²⁷ and then subsequently re-enacted²⁸ the year after to consolidate the amendments to Company Law statutes.

Section 332 of the Companies Act 1948²⁹ formed the totality of fraudulent trading provisions right up until the Companies Act 1985 when the criminal and civil provisions were split and the civil subsection was hived off to become s.213 of the Insolvency Act 1986.

However it is pertinent to note that under the 1948 Act, the maximum sentence was doubled from one to two years imprisonment and the possibility of a fine of £500 was included which could be imposed in addition to or instead of imprisonment³⁰. Furthermore the addition of a fine is not insignificant as according to the National Archives, the buying power of £500 in 1950, just two years later, was equivalent to £11, 390 of today's money³¹.

This, it is submitted, is symptomatic of the rise in penalty for fraudulent trading with the rise in business culture and prosperity. After the Second World War when businesses were beginning to flourish once more and a great deal of optimism was abounding, it is contended that deviant corporate behaviour was also on the increase.

Then in 1962 yet another Company Law Committee report criticised the dual fraudulent trading provision. The Jenkins Committee pertinently noted the, 'widespread criticism' that the Companies Act drew because of its inadequacy in dealing with fraudulent trading as well as sheer directorial incompetence³². However, the Report directed its frustration as to the efficacy of the provisions not towards the Courts or the legal draftsmen, but at the Board of Trade due to its perceived failure in bringing cases to court³³. It was felt that the uncertainty of the standard of proof may have contributed to this failure as Beekman and Ross highlight³⁴ and this was despite the fact that the question of standards of proof in civil cases was by then settled law.

²⁷ Companies Act 1947, s.101.

²⁸ Companies Act 1948, s.332.

²⁹ Set out in full in Appendix 2, p.110 below.

³⁰ Companies Act 1948, s.332(3).

³¹ The National Archives, 'Currency Converter' <<http://www.nationalarchives.gov.uk/currency/results.asp#mid>> accessed 2nd May 2011.

³² Board of Trade, *Report of the Company Law Committee* (Cmnd 6659, 1962), 193.

³³ *Ibid*, 194.

³⁴ M. Beekman and S. Ross, 'Fraudulent or Wrongful Trading' (1991) 141 *NLJ* 1744.

Indeed it was Denning LJ (as he then was) who held in *Hornal v Neuberger Products Ltd*³⁵ that the standard, 'need not, in a civil case reach the very high standard required by the criminal law'³⁶ but was instead merely the balance of probabilities.

As Farrar points out³⁷, the Jenkins Committee also recommended that recklessness as well as incompetence should be included to widen the net of liability although these suggestions were then subsequently ignored in the development of fraudulent trading by legislators.

Finally, in 1982 the Cork Committee³⁸ completed a fairly radical overhaul of U.K. insolvency law and this much narrower remit, as well as a focus on formulating a comprehensive scheme of insolvency practices³⁹, led to the divorce of the criminal and civil provisions for fraudulent trading. The Cork Report cited the difficulties faced by liquidators in bringing civil proceedings on the same evidence as that used in criminal trials. This was what brought the Committee to recommend their, 'radical reappraisal' of s.332 of the Companies Act 1948⁴⁰. However, another possibility which must be articulated relates to the cost and efficiency of fraudulent trading procedures.

The Cork Committee was asked to, 'suggest possible less formal procedures as alternatives to...winding up proceedings'⁴¹ as one their terms of reference. Yet, the deliberate separation of criminal and civil provisions into separate statutes, coupled with the introduction of wrongful trading, tentatively points towards the Committee perhaps trying to streamline the use of what became s.213 of the Insolvency Act 1986.

Meanwhile, the entirely new concept of wrongful trading was introduced and sought to encompass the incompetent and reckless behaviour which the Jenkins Committee had decried⁴². As noted already in chapter 1, it is admittedly easier to meet the requirements for s.214 whilst ending up with the same result for liquidators⁴³ - though crucially against **directors** only. Therefore *prima facie*, s.214 wrongful trading could have sealed the fate of s.213 by making it irrelevant and a victim of the Cork Committee's desire to provide liquidators and therefore creditors with a more straightforward way to pierce the corporate veil and recoup their losses. Yet, to repeat again the point already made in the first chapter, fraudulent trading has its own unique utility as both a criminal and civil provision which is strengthened by its ability, unlike wrongful trading, to encapsulate third parties.

³⁵ [1957] 1 QB 247.

³⁶ Ibid, 258.

³⁷ Farrar (n.14), 345.

³⁸ Review Committee, *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558, 1982).

³⁹ Ibid, iii.

⁴⁰ Ibid, 394-395.

⁴¹ Ibid, iii.

⁴² Ibid, chapter 44.

⁴³ A. Keay, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish, Abingdon 2007), 65.

Overall though, in its review of the provision set to become s.213 of the Insolvency Act 1986 when the Companies Act 1985 finally separated the two types of provision, the Committee notably neglected to alter or clarify the seemingly immovable phrase, “business of the company...[being] carried on with intent to defraud”. It is submitted that that was a great missed opportunity to elucidate this troublesome wording and suggest a less nebulous definition which could have then been approved by Parliament and enacted for the civil provision.

2.2.2-A Near Non-Occurrence

Importantly in the evolution of fraudulent trading emanating from the Cork Report, it must be highlighted that re-enacting fraudulent trading as a separate civil provision **very** nearly did not happen. The criminal provision⁴⁴ was never called in to question in being separated and re-enacted, but it is pertinent to examine this in greater detail for the Cork Report itself suggested strongly, that, ‘the whole of section 332 [of the Companies Act 1948] should be repealed as far as it provides a civil remedy’⁴⁵ and it should be replaced and not instead complemented with the new concept of “wrongful trading”⁴⁶.

These comments therefore beg the question as to why fraudulent trading still made its way onto the Statute Book in 1985 as a civil provision, s.458 of the Companies Act 1985⁴⁷, when the Cork Committee had suggested its removal as well as providing a potentially viable alternative. Furthermore, it is even more curious to find that right up until just before the final reading of the Insolvency Bill in the House of Lords, wrongful and fraudulent trading were oddly blurred together.

This blurring began with fraudulent trading being incorporated as a head or instance of wrongful trading:

Wrongful Trading.

9.—(1) A company shall be trading wrongfully within the meaning of this section if —

(a) any business of the company is carried on with the intent to defraud creditors of the company or creditors of any other person or otherwise for any fraudulent purpose; or

⁴⁴ Under what became the Companies Act 1985, s.458.

⁴⁵ Review Committee (n.38), 399.

⁴⁶ Review Committee (n.38), 400-401.

⁴⁷ Appendix 3, p.111 below.

(b) at a time when the company is insolvent or unable to pay its debts as they fall due it incurs further debts or other liabilities to other persons without a reasonable prospect of meeting them in full.⁴⁸

This was in fact even supported by Lord Denning sitting in the House of Lords who both sang the praises of the Cork Committee whilst oddly whole-heartedly agreeing to the above formulation- even though it went entirely against the Committee's recommendations⁴⁹!

The Government however would not agree to such a formulation and Lord Lucas (then-Under-Secretary of State for Trade and Industry) retorted that the suggested multi-faceted wrongful trading clause, 'would allow the courts [sic] to deal with both fraudulent and non-fraudulent trading on the same basis. In our view, that is wrong. Declarations of personal liability for fraudulent trading are already provided for by s.630 of the Companies Act 1985^{50,51} (N.B.- this was the post-separation provision for civil fraudulent trading before the Insolvency Act 1986 was passed).

Curiously, wrongful trading was then re-jigged so as to incorporate s.630 of the Companies Act 1985 and this persisted right through all of the draft Insolvency Bills⁵² until its very last reading⁵³. As mentioned above, s.630 (revoked by the Insolvency Act 1986⁵⁴) purported to impose personal civil liability for fraudulent trading in similar terms to what thereafter became s.213, notwithstanding any criminal sanction(s) imposed for the same behaviour. *Locus standi* for such actions was however the same as under previous fraudulent trading sections, and not limited to only liquidators.

It is therefore clear that s.213 or indeed a separate s.213 from s.214 was in fact very nearly a total non-occurrence.

The Companies Act 1985 meant that criminal and civil provisions relating to fraudulent trading had finally been separated. However, in moving criminal fraudulent trading to s.458, it is very important to highlight that the phrase, "in the course of the winding up of a company" is deliberately omitted. The notion that fraudulent trading may only be dealt with in the civil and/or criminal courts when a company is being wound up at the very earliest was therefore ignored as far as criminal law consequences are concerned.

⁴⁸ HL Deb 1st April 1985, vol 462, col 37 [emphasis added].

⁴⁹ Ibid, cols 41-42.

⁵⁰ Appendix 4, p.112 below.

⁵¹ Ibid, col 42.

⁵² For example clause 10 of Insolvency HL Bill (1985-1986) 127 and Insolvency HL Bill (1985-1986) 168.

⁵³ HC Deb 18th July 1985, vol 83, col 560.

⁵⁴ Insolvency Act 1986, sch 12.

This raises several issues. Firstly why and secondly what consequences does this have? For the moment, it is simply important to note that no longer did a company have to be wound up to charge someone with fraudulent trading. This issue will be dealt with below⁵⁵ as it is an extremely important distinction separating s.213 of the Insolvency Act and s.993 of the Companies Act.

2.2.3- Why no “in the course of winding up” for criminal fraudulent trading?

The answer as to why s.993 and its statutory criminal law ancestor⁵⁶ do not contain “in the course of winding up” is that the Courts forced Parliament’s hand. The case of *DPP v Schildkamp*⁵⁷ which was decided a few years prior to the Companies Act 1985 is responsible and in fact went all the way up to the House of Lords. By a bare majority, their Lordships held that Parliament had **not** intended criminal liability for fraudulent trading to be imposed when the company was still a going concern. It had to be being wound up when the behaviour was discovered so that prosecutions could only occur during the winding up process or with the company already having been wound up.

The Director of Public Prosecutions, on behalf of the Crown argued unsuccessfully, as Lord Hodson outlined⁵⁸, that “winding up” and references to the company being in liquidation were only made in and thus only relevant to subsection (1) of s.332 of the Companies Act 1948⁵⁹. The subsection almost exactly mirrored the current wording of s.213 of the Insolvency Act 1986.

However subsection 332(3) of the Companies Act, which imposed criminal liability whilst referring back to subsection 332(1), did **not** mention liquidation and the Crown argued that, ‘therefore the offence is unlimited in its scope and is not confined to cases where there has been a winding up.’⁶⁰

This logical but perhaps slightly pedantic argument was dismissed by three out of five members of the House of Lords Committee and the majority held that the whole section should be read together and that in any case, the benefit of any doubt should always go the defendant’s way.

The two dissenters essentially opined that Parliament had deliberately omitted the references to winding up in subsection 332(3) and it was not the place of the Courts to insert and impart meanings on subsections in statutes where they were not there⁶¹.

⁵⁵ See [2.3.2].

⁵⁶ Namely the Companies Act 1948, s.332(3).

⁵⁷ [1971] AC 1.

⁵⁸ Ibid, 11-12.

⁵⁹ See Appendix 2, p.110 below.

⁶⁰ Ibid, 11.

Such a division of opinion is rather striking and it is contended that as well as a desire of the minority to extend the remit of criminal fraudulent trading possibly given its success, the fact that the defendant had pleaded guilty cannot be overlooked. Although mentioned by way of setting out the facts by Lord Hodson giving the leading judgement, it is reiterated by both dissenting judges if only subconsciously⁶² in both of their opening remarks. Therefore it is submitted that the defendant's plea may have impacted on their decisions and a desire to not let him get away with it on a technicality.

However, this important split-decision was noted by Parliament though it took over a decade for any practical effect to materialise. By enacting s.96 of the Companies Act 1981, Parliament took the side of the House of Lords dissenters in *DPP v Schildkamp* in that they removed the requirement for a company to be wound up in order for defendants to be criminally liable for fraudulent trading⁶³. This therefore created a definitive and critical difference between civil and criminal provisions for fraudulent trading and this difference was further strengthened when the two different elements were put into different statutes in 1986 and 1985 respectively. It also vastly widened the remit of fraudulent trading under the criminal law and perhaps sent a signal about parliamentary intent in terms of being more robust towards deviant corporate behaviour; something which has certainly continued.

One final mention of s.96 of the Companies Act 1981 is necessary as in *R v Sutcliffe-Williams*⁶⁴ an attempt was made to make its effect retrospective. The defendant was charged with fraudulent trading prior to the enactment of s.96 but the company which had been used a vehicle for the offending behaviour had never been wound up.

The prosecution still succeeded in convicting the defendant at first instance even though, and contrary to the requirements of s.332 of the Companies Act 1948, there was no winding up and so the defendant's behaviour could never have been discovered, "in the course of the winding up"- precisely just as in *DPP v Schildkamp*.

The Court of Appeal dismissed this effort to apply s.96 retroactively and quashed the conviction. Yet the mere fact that an attempt was made perhaps reiterates the tenacity and willingness to pursue a charge of fraudulent trading by the Crown- even in the early 1980s as the financial sector of the economy was beginning to grow a great deal.

⁶¹ Ibid, 15 and 21-22.

⁶² Ibid, 13 and 15.

⁶³ Beekman and Ross (n.34), *ibid*.

⁶⁴ Reported in [1983] Crim LR 255.

Shortly afterwards, in 1985, a new Companies Act was introduced which consolidated and revised a great deal of company law. It is also the point at which criminal and fraudulent trading were separated since s.332(3) of the older Companies Act 1948 was transferred to its own stand-alone provision under s.458 of the new 1985 Act.

Furthermore, the offence changed from being indictable-only to being triable either-way. This perhaps suggests a greater clamp-down on fraudulent trading in that even minor instances of the offence previously deemed perhaps too trivial to warrant a full jury trial at the Crown Court would be able to be dealt with summarily by magistrates.

More strikingly and indicative of the grave seriousness with which the offence was then to be treated, was the massive increase in maximum sentence from two years⁶⁵ and/or a fine of £500 up to seven years imprisonment and/or a fine which was to be set by the sentencing judge or magistrate⁶⁶.

For reference, the enacted civil fraudulent trading provision, s.213 of the Insolvency Act 1986, is as follows:

s.213 Fraudulent trading.

(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

And the (re)enacted⁶⁷ criminal fraudulent trading provision under s.993 of the Companies Act 2006 is as follows:

⁶⁵ Under the Companies Act 1948, s.332(3).

⁶⁶ In the Companies Act 1985, schedule 24.

⁶⁷ From the Companies Act 1985, s.458.

s.993 **Offence of fraudulent trading.**

(1) If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence.

(2) This applies whether or not the company has been, or is in the course of being, wound up.

(3) A person guilty of an offence under this section is liable—

(a) on conviction on indictment, to imprisonment for a term not exceeding ten years or a fine (or both);

(b) on summary conviction—

(i) in England and Wales, to imprisonment for a term not exceeding twelve months or a fine not exceeding the statutory maximum (or both);

...

2.2.4-The Extension of Criminal Fraudulent Trading

Slightly more must be said about the criminal provision for fraudulent trading as it continued to develop well beyond the Companies Act 1985 and its separation from what became s.213 of the Insolvency Act.

It is submitted that its continued development highlights the increased importance to corporate policy makers of good corporate governance as the economic boom of the 1980s and late 1990s became apparent.

2006 saw two crucial developments in the criminal provision for fraudulent trading. Firstly, the Fraud Act 2006 which, pursuant to s.9 of that Act, greatly extended the scope of the offence to other forms of carrying on business where there is not any sort of incorporation- such as sole traders and trusts. This change, *per* the accompanying explanatory notes⁶⁸, was due to Law Commission recommendations in their report on multiple offending⁶⁹ and the Fraud Act came into force in January of 2007 whilst the new Companies Act came into force in October of that year.

⁶⁸ Explanatory Notes to the Fraud Act 2006, para. [29].

⁶⁹ Law Commission, *The Effective Prosecution of Multiple Offending* (Law Com No. 277, 2002).

It must be evinced that there was also some frustration from the Crown Prosecution Service and other prosecuting authorities at procedurally being unable to go after unscrupulous business practice which was not strictly done through a company vehicle. For example in *R v Stanton*⁷⁰ the prosecution was criticised for not having, ‘their tackle in order’⁷¹ by attempting to do just that, but their frustration is imaginably and understandably clear.

Furthermore, s.10 of the Fraud Act increased the length of maximum sentence from seven up to ten years which certainly is not insignificant as it places it on a sentencing par with crimes including indecent assault⁷², making a threat to kill⁷³ and child cruelty⁷⁴.

The dramatic increase in sentence length from an original one year, with the offence being indictable only⁷⁵ up to ten years imprisonment and/or a fine⁷⁶ and being triable as an either-way offence⁷⁷ is far from insignificant. The increase was instigated by the Company Law Review Steering Group in their main report in 2001 due to the fact that it, ‘provides a valuable weapon in countering crime.’⁷⁸ Indeed, they also specifically examined the option of placing much more emphasis on civil remedies but, significantly, they were unconvinced by arguments for decriminalisation⁷⁹.

It is submitted that it is also directly indicative of the growing culture of tackling misfeasance in business and what one might broadly label “white collar crime” which Henham details in his excellent article⁸⁰. It will be argued below that this significant change in the nature of s.993 is part of an important distinction from its s.213 Insolvency Act counterpart.

The most recent development in the legislative history of fraudulent trading is its modern incarnation as s.993 of the Companies Act 2006. In terms of the provision’s wording of the nature of the offence, nothing was altered from the 1985 Act. Instead, it sought to simply bring together the disparate elements of wording from s.458 of the Companies Act 1985 and the increase in maximum penalty upon conviction on indictment⁸¹ under one single section.

⁷⁰ [2005] EWCA Crim 3463.

⁷¹ Ibid, [46].

⁷² Sexual Offences Act 2003, s.3(4)(b).

⁷³ Offences Against the Person Act 1861, s.16.

⁷⁴ Children and Young Persons Act 1933, s.1.

⁷⁵ Companies Act 1928, s.75(3).

⁷⁶ Fraud Act 2006, s.10.

⁷⁷ Brought in under the Companies Act 1985, s.458.

⁷⁸ The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy: Final Report (Volume 1, 2001)*, para [15.7].

⁷⁹ Ibid, para [15.4].

⁸⁰ R. Henham, ‘Sentencing Policy and Economic Crime’ (1998) 6 Journal of Financial Crime 15.

⁸¹ *Per* the Fraud Act 2006, s.10.

This was perhaps for ease of reference but also, it is contended, perhaps for added emphasis on the draconian consequences of falling foul of this provision; the penalty is clearly set out underneath the offence so any wary person immediately knows the consequences of his or her actions⁸².

2.3-Key elements to fraudulent trading

2.3.1-Introduction

It is intended to deconstruct and analyse the key components of both fraudulent trading provisions given their shared heritage and jurisprudential cross-over and, in doing so, expose the ineffectiveness and potential difficulties arising from this heritage and cross-over. Then meaningful analysis of both the s.993 Companies Act criminal provision and the s.213 Insolvency Act civil provision can be effected.

Both fraudulent trading provisions can usefully be broken down into several key elements; some of which are more problematic than others. Notably, the parts unique to s.213- the “in the course of the winding up” and the element dealing with liquidators will be examined alongside criminal fraudulent trading in the order that they appear in s.213 of the Insolvency Act. Even though they are unique to civil fraudulent trading, this is to maintain a sensible and logical order but they will be differentiated from those elements also applicable to criminal fraudulent trading with an asterisk.

Deconstructing fraudulent trading

*2.3.2- “in the course of the winding up”

Firstly, the phrase, “in the course of the winding up of a company” is not problematic *per se* given that the Insolvency Act 1986 clearly delineates what is meant by this as well as outlining the various procedures by which this can occur⁸³. However in highlighting this, it must be recalled that for s.213 to apply, the behaviour may only be impugned once the company is being wound up. With regards to s.993 of the Companies Act 2006, s.213’s sister criminal law provision, the proscribed behaviour

⁸² To be contrasted back with the tort of deceit- see [1.4.2] above.

⁸³ Insolvency Act 1986, part IV.

may be penalised whilst the company is still in normal full legal existence and not being subjected to insolvency procedures⁸⁴.

Williams condemns the fact that fraudulent trading civil provisions are only engaged when companies are being wound up⁸⁵. Indeed, he contends that a company's, 'viability may be testament to its success in fraudulent trading endeavours'⁸⁶ and so he submits that the remit of s.213 ought to be widened so that creditors do not have to wait for the company to be in liquidation in order to halt the errant behaviour (ultimately via a liquidator). This, he argues, would make the fraudulent trading provision, 'far more sensible' if it were unrestrictedly applied to all companies⁸⁷.

This submission is analysed more fully below⁸⁸, but it will be argued that Williams' contention is exaggerated in that creditors can themselves force a company to be wound up as and when the fraudulent trading is discovered. Therefore to argue that s.213 is severely hamstrung by narrowing its application only to companies "in the course of being wound up" is a rather overstated claim.

2.3.3- "with intent to defraud"

The need to evince an "intent to defraud" by the defendant(s) is the most problematic element of the whole of fraudulent trading and has troubled both commentators and the Courts for some time⁸⁹. Indeed, the great difficulty of making out this key element in the context of the civil wrong has meant that s.213 is perhaps much more infrequently used than it should be⁹⁰.

Fletcher aptly highlights that, 'there has been a lack of consistency over the years regarding the judicial approach to formulating the test of fraudulent conduct...which is to be applied in cases falling under s.213 and its statutory antecedents.'⁹¹

In tracing the development of the notion of "intent to defraud", it must be noted that two cases, both decided by Maugham J under a year apart, dominated the interpretation of this requirement for fraudulent trading for the best part of half a century. Furthermore, it is also noteworthy that neither case had an adjournment after it was decided so as to allow for the formulation of the

⁸⁴ Companies Act 2006, s.993(2).

⁸⁵ R.C. Williams, 'Fraudulent Trading' (1986) 4 Company & Securities Law Journal 14, 17.

⁸⁶ Ibid.

⁸⁷ Ibid.

⁸⁸ See [3.3.1] below.

⁸⁹ Keay (n.21), 122.

⁹⁰ A. Savirimuthu, 'Case Comment: *Morphitis* in the Court of Appeal: Some Reflections' (2005) 26 Company Lawyer 245, 245.

⁹¹ I.F. Fletcher, *The Law of Insolvency* (4th edn, Sweet & Maxwell, London 2009), 851.

reasons for the judgement- as indicated by the lack of *curia advisari vult* or abbreviations thereof in the Law Reports. From this, we can infer that Maugham J in both cases delivered his reasons fairly spontaneously which may perhaps go some way in trying to explain these similar but, *per* Keay, 'inconsistent'⁹² judgements.

*Re William C. Leitch Brothers Ltd*⁹³ was the first judicial consideration of s.275 of the Companies Act 1929⁹⁴ (and its legislative successors) and the construction of the wording "intent to defraud" was immediately identified as, 'a question of great difficulty.'⁹⁵ This plainly highlights the phrase's inherently problematic nature. Furthermore, Maugham J set out a fairly broad test which based intention upon the directors⁹⁶ incurring debts when they knew there was no reasonable chance of repayment of their creditors⁹⁷. In this case he found for the plaintiffs.

However, within a year in *Re Patrick and Lyon Ltd*⁹⁸ Maugham J narrowed his earlier interpretation of s.275. Whilst re-emphasising the difficulty of construing this, 'very remarkable section'⁹⁹, he went on to focus the targeted behaviour of s.275 to that which concerned, 'actual dishonesty involving... real moral blame.'¹⁰⁰ This definition has continued to be considered with approval in subsequent modern caselaw¹⁰¹ but only to an extent. In *Re L Todd (Swanscombe) Ltd*¹⁰² it must be noted however that the finding against the defendant on this point was based **solely** on the fact that he admitted he, "'had not intended to defraud the company's creditors (other than H.M. Customs and Excise)'"¹⁰³ for there was no intention to defraud creditors other than H.M. Customs and Excise found.

However, the notion of the immorality or "anti-social" nature of fraudulent trading (as Williams puts it¹⁰⁴) raises questions with regards to whether the current civil procedures under s.213 of the Insolvency Act for fraudulent trading are appropriate or effective¹⁰⁵.

⁹² A. Keay, *McPherson's Law of Company Liquidation* (2nd edn, Sweet & Maxwell, London 2009), [16.020].

⁹³ [1932] 2 Ch 71.

⁹⁴ See the Appendices for an outline of these (pages 109-112 below).

⁹⁵ *Ibid*, 77.

⁹⁶ For it must be recalled that fraudulent trading was back then an action which could be brought by creditors against directors only.

⁹⁷ *Ibid*.

⁹⁸ [1933] Ch 786.

⁹⁹ *Ibid*, 789-790.

¹⁰⁰ *Ibid*, 790.

¹⁰¹ *Re L Todd (Swanscombe) Ltd* [1990] BCC 125, 128.

¹⁰² *Ibid*.

¹⁰³ *Ibid*, 127.

¹⁰⁴ Williams (n.85), *ibid*.

¹⁰⁵ Examined in chapter four.

Williams further astutely observes that this diversity in the construction to be given to “intent to defraud” by Maugham J gave rise to a great deal of interpretative difficulty¹⁰⁶. It is contended that this is furthermore exacerbated when one considers that this same test is applied to **both** civil and criminal proceedings.

Indeed, Marshall J held in *R v Inman*¹⁰⁷ that the section (s.332 of the Companies Act 1948)’s terms can be split as it, ‘dealt with two different types of offence, fraudulent trading with intent and fraudulent trading for the purpose of achieving certain things.’¹⁰⁸ As Parry *et alii*¹⁰⁹ highlight, this frames fraudulent trading very widely indeed. So widely in fact that it is potentially on the verge of engaging the E.C.H.R. on the grounds of a lack of legal certainty.

This therefore makes the Cork Committee’s decision in their report of 1982 to neither clarify the problematic “intent to defraud” phrasing nor considering it appropriate to examine the possibility of applying an alternative standard for the requisite mindset for the civil fraudulent trading provision hard to comprehend. It is strongly submitted that this was a prime opportunity missed to alter the most problematic and troublesome element of fraudulent trading.

However in *Re White and Osmond (Parkstone) Ltd*¹¹⁰ Buckley J held that:

What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear the company will never be able to satisfy its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them to get over the bad time.¹¹¹

This clarified and attempted to reconcile the two decisions of Maugham J from the 1930s. Whilst directors and managers may incur credit which, given their company’s financial situation, *prima facie* appears dishonest or verging on reckless, this must not impugn genuine business optimism. It must be recalled however that all entrepreneurship involves a degree of risk-taking and business optimism.

¹⁰⁶ Williams (n.85), 26.

¹⁰⁷ [1967] 1 QB 140.

¹⁰⁸ Ibid, 148.

¹⁰⁹ J. Parry *et alii*, *Arlidge and Parry On Fraud* (3rd edn, Sweet & Maxwell, London 2007), 200-208.

¹¹⁰ Unreported (30th June 1960) but quoted in both I.F. Fletcher *et alii* (eds), *Palmer's Corporate Insolvency* (Looseleaf Sweet & Maxwell, London), 1249 and *R v Grantham* [1984] QB 675, 682.

¹¹¹ Ibid.

*R v Peter Nevill Cox*¹¹² is a vitally important case which is perhaps overlooked on occasion for it evidences what has become a key feature of fraudulent trading and the manner in which it is dealt with in criminal courts.

The defendant was charged under s.332 of the Companies Act 1948 of which subsection (1) was what we recognise to be modern civil fraudulent trading and subsection (3) of which became s.993 of the Companies Act 2006. It was held that the trial judge had seriously misdirected the jury in telling them that dishonesty was not essential in the “intent to defraud” element. Indeed, it was recommended by Watkins LJ that the authoritative criminal practitioners’ work *Archbold* be reviewed, ‘so as to make it clear that dishonesty is an essential ingredient of the **offence** created by section 332.’¹¹³

It is thoroughly important to note two things. Firstly that the case related solely to criminal fraudulent trading and secondly the words used by the Court of Appeal should be more closely re-examined in that the phrase “offence created by section 332” is used. This therefore strongly suggests that dishonesty applies only to criminal and not civil proceedings. Indeed, the fact that in this case fraudulent trading is so very closely associated with fraud in general and especially the common law crime of “conspiracy to defraud” in the caselaw¹¹⁴ strongly adds to the argument that fraudulent trading is perhaps better left to the criminal rather than civil jurisdiction.

Keay in his commentary on “intent to defraud” stated that, ‘Where s 458 [now s.993] is concerned, the notion does not appear to be different from the concept of dishonesty in general criminal cases’¹¹⁵. Yet it is contended that whilst strictly correct, this is also applicable where s.213 of the Insolvency Act 1986 is concerned. There is not, initially at least, an actual bifurcation or distinction between the “intent to defraud” in criminal and civil cases for both bodies of law incorporate each other’s lines of caselaw to divine the meaning of this phrase.

In fact, following both *R v Peter Nevill Cox* and *R v Grantham*¹¹⁶, the *Ghosh*¹¹⁷ test of dishonesty was brought in; something well-known and recognised in deception offences under the Theft Act 1968 (though such offences are now repealed by the Fraud Act 2006) as well as other dishonest-based crimes. It was *R v Lockwood*¹¹⁸ which incorporated the standard and this has stood the test of time;

¹¹² (1982) 75 Cr App R 291.

¹¹³ Ibid, 296 [emphasis added].

¹¹⁴ S. Farrell, N. Yeo and G. Ladenburg, *Blackstone’s Guide To The Fraud Act 2006* (OUP, Oxford 2007), 82.

¹¹⁵ Keay (n.43), 52.

¹¹⁶ [1984] QB 675.

¹¹⁷ *R v Ghosh* [1982] QB 1053.

¹¹⁸ (1986) 2 BCC 99333.

it has been cited with approval by the House of Lords in *Powdrill v Watson*¹¹⁹ and *Re Leyland Daf Ltd*¹²⁰ which were s.213 cases which *inter alia* widened the liability of receivers under s.213.

R v Grantham, a further criminal case under s.332 of the Companies Act 1948 is of great import in the development of “intent to defraud”. Lord Lane CJ reviewed the preceding caselaw (crucially both civil and criminal in nature) under s.332 and distilled their *rationes decidendi* down into the proposition that “deliberate dishonesty” (a phrase he borrowed from *R v Sinclair*¹²¹) was a central plank of “intent to defraud”¹²². Indeed, it must be noted that *R v Sinclair* did not concern any fraudulent trading whatsoever but instead the indicted offence was that of common law conspiracy to cheat and defraud. This fact would not be significant if *R v Grantham* were not so central to s.213 cases where this issue arises.

Crucially, it might be argued that as Messieurs Lockwood and Grantham were charged under s.332(3) of the Companies Act 1948 which purported to impose criminal liability **only**, this would not apply to civil liability and therefore the “intent to defraud” under s.213 of the Insolvency Act. However, it is contended that the cross-application of “intent to defraud” was brought about by *DPP v Schildkamp* decided over a decade earlier which went all the way up to the House of Lords.

Although ruling on a different element of apparent discrepancy between subsections 332(1) and 332(3) surrounding whether the company needed to be wound up in *DPP v Schildkamp*, three out of five members of the House of Lords Committee held that the whole of s.332 should be read together and that, ‘the civil liabilities under subsection (1) and the criminal liability under subsection (3) were in pari materia’¹²³. Therefore, whilst not specifically considered as the direct legal point, their ruling on the reading of s.332 as a whole with subsection 332(3) being reliant on the **precise** wording of subsection 332(1) may, it is contended, be regarded as the watershed whereby criminal notions surrounding “intent to defraud” became fused with civil law thinking found in earlier caselaw¹²⁴ which then carried on into s.213 as is demonstrated in the next section.

¹¹⁹ [1995] 2 AC 394, 407-408.

¹²⁰ [1994] BCC 658, 668.

¹²¹ [1968] 1 WLR 1246, 1249.

¹²² (n.116), 683-685.

¹²³ (n.57), 14-15 and 25.

¹²⁴ For example *Re William C. Leitch Brothers Ltd* (n.90), *ibid*.

2.3.4- Criminalisation of “intent to defraud”

Following *R v Grantham*, the decisions of *Rossleigh Ltd v Carlaw*¹²⁵ and *Re EB Tractors Ltd*¹²⁶ decided in Scottish and Northern Irish courts respectively provided the clearest indication of the direction s.213 would take with regards to this imported criminal law spin on the concept of “intent to defraud”. In *Rossleigh Ltd v Carlaw*, Lord McDonald held that, ‘when it [s.332] speaks of intent to defraud it is referring, in my opinion, to fraud in the **criminal** sense.’¹²⁷

In the latter case, *Re EB Tractors Ltd*, reviewing the approach taken in *R v Grantham*, Murray J adopted a much narrower stance towards “intent to defraud”. Rather than focussing, *per Re William C. Leitch Brothers Ltd*, on the factual financial situation with debts being accumulated by the company in the knowledge that there was no reasonable prospect of them ever being paid, he approved the *Grantham* notion of “deliberate dishonesty”¹²⁸. This equation in *Re EB Tractors Ltd* had the effect of ending the uncertainty brought about by the small but significant differences in Maugham J’s two judgments early in the life of the fraudulent trading provision. These differences, it is argued, led to civil proceedings under s.332 of the Companies Act 1948 previously being scarcely brought- a fact which Savirimuthu has highlighted¹²⁹.

Furthermore, the simlizing of “intent to defraud” exclusively with “deliberate dishonesty” continued¹³⁰ right up until a fairly recent flurry of caselaw within the last decade or so when a much wider range of factors was considered.

It is argued that this was brought about because all the caselaw outlined above was under the dual fraudulent trading provision of s.332 of the Companies Act 1948 (including the strong remarks in *Rossleigh Ltd v Carlaw*) as the Insolvency Act 1986 only came into force on the 29th December 1986¹³¹.

The first such case which, harking back to the concerns of Buckley J in *Re White and Osmond (Parkstone) Ltd*, altered the interpretation of “intent to defraud” was decided by Lord Hoffmann sitting in the Hong Kong Court of Final Appeal and was several years post the Insolvency Act 1986’s enactment.

¹²⁵ 1986 SLT 204.

¹²⁶ [1986] NI 165.

¹²⁷ (n.125), 205-206 [author’s own emphasis].

¹²⁸ (n.126), 171.

¹²⁹ Savirimuthu (n.90), *ibid*.

¹³⁰ For instance *Brown v City of London Corp* [1996] 1 WLR 1070, 1088.

¹³¹ *Per* the Insolvency Act 1986, s.443 in conjunction with the Insolvency Act 1985 (Commencement No. 5) Order 1986, SI 1986/1924.

The relevant provision in the Hong Kong insolvency law regime dealing with fraudulent trading¹³² is an exact copy of that under s.213 of the Insolvency Act 1986 and so is extremely relevant in the interpretation of our domestic fraudulent trading jurisprudence. In *Aktieselskabet Dansk Skibsfinansiering v Brothers*¹³³ his Lordship opined that a much more holistic approach should be taken with facts dealt with on a case-by-case basis to determine liability¹³⁴. Furthermore, an element of leeway should be afforded to directors who genuinely believe that by incurring more debts their company might possibly survive; it was noted that ‘the fact that the likelihood of survival is objectively low is not inconsistent with honesty.’¹³⁵

Whilst *prima facie* this seems like an abrupt change from the “deliberate dishonesty” of earlier caselaw, it was in fact a vast widening of the factors to be taken into account when deciding whether defendants were “deliberately dishonest” or not. Lord Hoffmann proffered a much more rounded approach which maintained the element of *Ghosh* dishonesty seen in previous caselaw as Keay highlights¹³⁶, and also allowed directors to take business decisions in the so-called “twilight zone” of their companies without being caught under s.213 if their aims were honourable and their purpose was to try and save their business.

It is contended that Lord Hoffmann explicitly set out to ensure that entrepreneurship and risk-taking were not prevented or prohibitively discouraged due to the adverse impact it could have on business decision-making.

However, this does aptly highlight the much wider issue of whether it is right and proper for judges to be assessing business decisions in the Courts. Indeed, this unease has been espoused by commentators ever since the inception of fraudulent trading. Wortly back in 1934 asked, ‘Is it not somewhat strange to find the standards of commercial men taken as a guide for the Court of Chancery in the interpretation of the section...?’¹³⁷

The meaning of s.213’s “intent to defraud” was thoroughly reviewed and once more considered in *Morphitis v Bernasconi*¹³⁸ by the Court of Appeal.

Whilst the current interpretation of the phrase seemed to meet the Court of Appeal’s overall approval, Chadwick LJ in his judgement appeared to cite *Re Gerald Cooper Chemicals Ltd*¹³⁹ as his

¹³² Companies Ordinance (Hong Kong), s.275.

¹³³ [2001] 2 BCLC 324.

¹³⁴ *Ibid*, 334.

¹³⁵ *Ibid*, 338.

¹³⁶ Keay (n.43), 58.

¹³⁷ B.A. Wortley, ‘The Interpretation of the New ‘Fraudulent Trading Section’ of the Companies Act 1929’ (1934) 50 LQR 405, 409.

¹³⁸ [2003] Ch 552.

authority¹⁴⁰. However, whilst *Re Gerald Cooper Chemicals Ltd* reiterates the standard of “deliberate dishonesty”¹⁴¹, it is normally cited as authority for the proposition that even just one single transaction defrauding a sole creditor can come under the remit of s.213 of the Insolvency Act. Understandably therefore, the Court of Appeal’s judgement has attracted some criticism given that it curiously overlooked a good deal of the later caselaw such as *R v Grantham*¹⁴². Yet this suggests that the Court of Appeal was perhaps trying to move away from the doctrinal heritage of *Grantham* and the earlier criminal fraudulent trading cases by citing authority only based on civil action caselaw.

Despite this however, a good deal of certainty can be gleaned from the unchallenged notions surrounding “intent to defraud”. The general proposition from *Morphitis v Bernasconi* is that for behaviour to fall under s.213(1) of the Insolvency Act, there must be dishonesty in the form of incurring company debts by those in charge when either they know that they will not be repaid or there is a substantial and unreasonable risk that they will not be. Indeed, Chadwick LJ accepted counsel for the directors’ submission that, ‘There is a distinction between a fraud on a person that gives rise to a claim in damages against the company and the carrying on of the business of the company with intent to defraud’¹⁴³ in which she cited the *Ghosh* dishonesty standard. Furthermore, no contradiction was made of the High Court’s judgement that the test for dishonesty in “intent to defraud”, ‘**must** be...the *Ghosh* test’¹⁴⁴.

Overall therefore, a precise list of determinants of “intent to defraud” is difficult to pin down but with a very good degree of certainty it can be gleaned that the “dishonesty” element of the phrase is that of the criminal law and is subjective¹⁴⁵.

2.3.5- “creditors of the company or creditors of any other person”

At first blush, the term “creditor” can be easily overlooked given its plain meaning in ordinary business and legal parlance as a natural or legal person with a pecuniary claim against a company¹⁴⁶. However, in the context of fraudulent trading, it is important to ascertain what classes of persons may be caught under this meaning because creditors will then be able to seek pecuniary remedies to

¹³⁹ [1978] Ch 262.

¹⁴⁰ (n.138), 574-577.

¹⁴¹ (n.139), 267-268.

¹⁴² Keay (n.21), 122.

¹⁴³ (n.138), 556.

¹⁴⁴ [2001] 2 BCLC 1, 28.

¹⁴⁵ As evidenced by Keay (n.43), 134.

¹⁴⁶ *Per Halsbury’s Laws of England: Volume 15* (5th edn, Lexis Nexis, London 2009), para [1427].

try and recover some of their losses- either through the actions of the liquidator under s.213 or under a post-conviction process flowing from a successful prosecution under s.993 of the Companies Act.

The first case to seriously consider the question of creditors' rights under civil fraudulent trading was *Re Cyona Distributors Ltd*¹⁴⁷ in which Lord Denning MR held that the Courts had (for previously creditors themselves could bring fraudulent trading civil actions) a very wide discretion over whom an order may be made in favour of¹⁴⁸. Although not of use in ascertaining the meaning of "creditor", it did highlight their plight and in fact served to boost the lot of the audacious creditor who decided to launch an action by himself as he could retain the damages gained. This latter aspect however is now of far lesser relevance given that liquidators alone are permitted to make s.213 applications.

However, *R v Kemp*¹⁴⁹ brought in the Crown Court under the criminal fraudulent trading subsection of the dual-provision was to have wide ramifications for claims by creditors (via liquidators) brought under s.213 civil fraudulent trading. It was held that "creditor" could encapsulate a far wider body of persons. This included potential creditors¹⁵⁰ (yet another imported notion from a criminal conspiracy to defraud case *R v Seillon*¹⁵¹) and also customers who were also to be treated as potential creditors¹⁵².

This is yet another example, and indeed it is argued a very important one with significant consequences, of the vast widening of the remit of fraudulent trading.

2.3.6- "any fraudulent purpose"

This element is relatively straight-forward and uncontentious simply because of its rarity in being used as the ground of appeal. "Carrying on business ...for any fraudulent purpose" almost always refers to some manner of defrauding the company's creditors. If it is genuinely for a fraudulent purpose by itself, such as selling fake antiques or for unscrupulous accounting practices then it will almost always come under the remit of a more general fraud offence; such as under the Fraud Act 2006.

¹⁴⁷ [1967] Ch 889.

¹⁴⁸ *Ibid*, 902.

¹⁴⁹ [1988] QB 645.

¹⁵⁰ *Ibid*, 649-650.

¹⁵¹ [1982] Crim LR 676.

¹⁵² (n.149), 654-655.

*Re Murray-Watson Ltd*¹⁵³ provided what little judicial enunciation there has been in the Civil Courts on the phrase. Oliver J offered the example of a second-hand car dealer fraudulently misrepresenting the performance and age of his wares yet this would surely be dealt with by criminal provisions under the Fraud Act 2006 or its statutory ancestors. One cannot realistically imagine a victim of such an act opting for a civil remedy- perhaps an enforcement of trading regulations at best.

*2.3.7- “on the application of the liquidator”¹⁵⁴

Having regard to only the black letter Law, this is an uncontroversial part of s.213 only which was introduced in the 1986 Act following the Cork Committee’s recommendations¹⁵⁵. However, this seemingly innocuous narrowing of potential litigants to that of liquidators only, has arguably had a much deeper practical effect. Prior to the Insolvency Act 1986, ‘the official receiver, or the liquidator or any creditor or contributory of the company’¹⁵⁶ could apply for relief in the Civil Courts for acts of fraudulent trading.

However, in the Committee’s extensive review of insolvency law, it did not even mention the other potential litigants besides liquidators. From this, one might logically infer that the previous fraudulent trading actions in the Civil Courts were brought by liquidators only. However, this is certainly not the case. Indeed the summonses in both *Re Patrick and Lyon Ltd* and *Re Gerald Cooper Chemicals Ltd* were issued by creditors, not liquidators- to name just two vitally important fraudulent trading cases.

It is therefore at first blush slightly perplexing that the Cork Committee would ignore the other litigants unless they surreptitiously but deliberately wanted to divest creditors and other contributories of the company of their *loci standi*. It is suggested there may be two different reasons for this. Firstly, to reinforce the *pari passu* rule of distribution of assets amongst creditors; which may rightly be regarded as being both equitable and fair.

For instance, a large creditor with a proportionally small amount of assets to recover in relation to the total it lends, may well have a great deal of resources (such as a bank). Such a creditor would

¹⁵³ Unreported (6th April 1977) but quoted in *Re Gerald Cooper Chemicals Ltd* [1978] Ch 262, 267.

¹⁵⁴ Recall that throughout this thesis the term “liquidator” specifically excludes the Official Receiver.

¹⁵⁵ See above.

¹⁵⁶ Companies Act 1948, s.332(1).

prima facie be extremely well placed to begin their own hypothetical s.332 Companies Act 1948 or s.213 Insolvency Act 1986 action whereas a much smaller creditor would not.

This could result in the larger creditor recovering all their losses and leaving no assets left for smaller, less powerful creditors to recover. They may also waste time and money on litigation only to then find there are no assets left in the liquidated firm¹⁵⁷. Whereas the *pari passu* distribution rule ensures an even division of the assets according to the amount lent.

A second reason could be to do with the regulation of those pursuing such actions¹⁵⁸. Liquidators are subject to fairly strict supervision from both industry regulators and provisions within statute law which govern their behaviour. Creditors and other contributories are naturally not subject to these stringent rules and regulations; although, they are required to adhere to regulations and statute law regarding their actual lending practices. Therefore, by prohibiting this far more nebulous body of potential litigants who are more loosely regulated (if at all¹⁵⁹) from taking civil fraudulent trading actions themselves, a certain degree of control can be exercised over actually when and in what circumstances the civil fraudulent trading provision is litigated. This may be through professional guidelines or industry advice to liquidators- for example only pursuing actions if losses are above a certain threshold to prevent too many cases clogging up the court system and so on.

Indeed, one industry observer, in calling for a single unified regulator, noted in 2002 that liquidators were subjected to the scrutiny of **eight** different regulators¹⁶⁰. It must also be noted that the Civil Courts do in theory have powers to strike out frivolous and vexatious claims under the Civil Procedure Rules (C.P.R.), Rule 3.4¹⁶¹. At first blush this may appear to preclude creditors from pursuing actions for miniscule claims but in reality it is infrequently invoked and only used in the most necessary and severe circumstances.

There are therefore arguments on both sides as to whether to restrict the field of plaintiffs with *locus standi* to bring s.213 actions or not. However, it is strongly contended that the formerly wider field, as under s.332 of the Companies Act 1948, would be undesirable. It may seem artificial and indeed contrary to the original intended aims of the fraudulent trading provisions to restrict the class of plaintiffs. Yet better-placed litigants will, more often than not it is argued, recover their

¹⁵⁷ An example of the problem which theorist T.H. Jackson identifies as the “common pool problem”. See [1.2.2].

¹⁵⁸ For legal regulation of liquidators under the Insolvency Act 1986, see A. Keay, ‘The Supervision and Control of Liquidators’ [2000] *The Conveyancer and Property Lawyer* 295.

¹⁵⁹ As in the case of trade creditors for example.

¹⁶⁰ J. Verrill, ‘The Insolvency Gremlins’ (2002) 16 *The Lawyer* 29, 29.

¹⁶¹ Lord Justice Waller *et alii* (eds), *The White Book Service 2010* (Sweet & Maxwell, London 2010), [3.4.1]-[3.4.3.1].

assets and leave virtually none for other creditors. Moreover there was not, as there is now, a large industry of thoroughly regulated and professionally qualified insolvency practitioners¹⁶².

It is conceded that the Cork Committee seems to have gravely overlooked providing a full and proper explanation for their narrowing of those with *locus standi* under fraudulent trading, yet the above review of the facts surrounding this position clearly demonstrates plausible and creditable rationales for doing so.

2.3.8- “persons ... parties to the carrying on of the business”(in the proscribed manner)

This element of fraudulent trading does however have applicability to both civil and criminal law provisions. Indeed, no clearer statement of the dual applicability of both fields of law in deciding cases post-separation in 1985 can be found than in the dicta of Neuberger J (as he then was) in *Morris v Banque Arabe Internationale d'Investissement SA (No.2)*¹⁶³. He stated unequivocally that he, ‘also accept[s] that decisions as to the meaning of s.458 of the 1985 Act are to be applied to s.213 of the 1986 Act.’¹⁶⁴

When dealt with in isolation with reference to the s.213 civil fraudulent trading provision, it perhaps represents the foremost advantage over the wrongful trading provision of s.214. Wrongful trading is restricted to activity only carried out by, ‘a person who is or has been a director of the company’¹⁶⁵. Fraudulent trading casts the net of liability much wider and therefore has the added advantage of allowing liquidators to recover assets from a range of defendants rather than just the directors of the company.

Examples may be found in *Re Gerald Cooper Chemicals Ltd*¹⁶⁶ where a creditor of the company used as a vehicle for the fraudulent trading was held liable and *Re Sarflax Ltd*¹⁶⁷ where “the carrying on of business” was held to also include the, ‘collection and distribution of assets in payment of debts’¹⁶⁸.

¹⁶² On insolvency practitioners generally see V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP, Cambridge 2009), chapter 5.

¹⁶³ [2002] BCC 407.

¹⁶⁴ Ibid, 413.

¹⁶⁵ Insolvency Act 1986, s.214(1). See also [1.3].

¹⁶⁶ (n.139), ibid.

¹⁶⁷ [1979] Ch 592.

¹⁶⁸ Ibid, 599.

In the former case, the unreported decision of *Re Murray-Watson Ltd*¹⁶⁹ was outlined and it has remained the mainstay of this element of fraudulent trading ever since¹⁷⁰.

In *Re Murray-Watson Ltd*- previously mentioned above¹⁷¹, Oliver J set out this definitive observation; that the meaning of this element of the fraudulent trading section:

is aimed at the carrying on of a business... and not at the execution of individual transactions in the course of carrying on that business...I do not think the words 'carried on' can be treated as synonymous with 'carried out,' nor can I read the words 'any business' as synonymous with 'any transaction or dealing.'¹⁷²

Much more recently in *Morris v Banque Arabe Internationale d'Investissement SA (No.2)*, Neuberger J (as he then was) rejected the assertion that **not** performing a managerial function would render a defendant outside the ambit of s.213(2)¹⁷³. He furthermore held that people actively and dishonestly assisting in and/or benefitting from a company's dishonest course of conduct would or at least could come within s.213(2)'s ambit¹⁷⁴.

However, he was also very careful not to widen s.213(2) too far so as to stifle and inhibit normal business practice¹⁷⁵. To do so could mean that non-directors and third parties would become overly-wary of the risk they expose themselves to in working for or dealing with a company which perhaps does not always adhere to the best business practice.

Halsbury's Laws of England also advises caution¹⁷⁶ with the Court of Session in the Scottish decision of *Rossleigh Ltd v Carlaw*¹⁷⁷ holding that for fraudulent trading purposes, 'being a director does not *eo facto* mean that a person is privy to all the transactions carried on by the company.'¹⁷⁸

This aptly demonstrates the fine line that the judiciary must tread to make provisions governing corporate behaviour both effective and workable without harming businesses economically and shows that they are treading this line well- at least in the context of fraudulent trading.

Also in *Morris v Bank of India*¹⁷⁹, a case closely related, a crediting bank was held liable for participating in the Bank of Credit and Commerce International (B.C.C.I.)'s massive fraudulent

¹⁶⁹ Ibid.

¹⁷⁰ So for example *Morphitis v Bernasconi* [2003] Ch 552, 574.

¹⁷¹ At [2.3.6].

¹⁷² Quoted in *Re Gerald Cooper Chemicals Ltd* [1978] Ch 262, 267.

¹⁷³ (n.163), 411-412.

¹⁷⁴ (n.163), 412.

¹⁷⁵ (n.163), 414.

¹⁷⁶ Lord Mackay of Clashfern (ed), *Halsbury's Laws of England* (4th edn-reissue, Lexis Nexis, London 2004), 7 (4), 169, n.8.

¹⁷⁷ Mentioned previously at [2.3.4] above.

¹⁷⁸ (1985) 1 BCC 99537, 99539.

trading and fraudulent practices. Both these cases are part of the vast swathe of litigation resulting from the collapse of B.C.C.I. in 1991.

Therefore s.213's utility over s.214 must be emphasised here. The ability to make other parties liable, especially if they are full of juicy assets- such as a bank, is extremely valuable. Keay also highlights this ability of s.213(2) to bring so-called "outsiders" into the fold of litigation¹⁸⁰.

2.3.9- "persons who were knowingly parties"

Knowledge of the carrying on of business in the proscribed manner is an uncontroversial element of the section. It is a rational proposition that to be liable, the party must know they are carrying out something themselves or assisting in the commission of something which is wrong. This is normally a question of fact which either the trial judge or another tribunal of fact must make a finding upon.

The notion of knowledge is, *prima facie*, straightforward. Watkins LJ for instance adopted the common-sense approach advocated by Lord Lane CJ in *R v Grantham* and indeed, it is more often than not a simple case of fact-finding¹⁸¹.

In some instances, such as in the Isle of Man case *Re Peake & Hall*¹⁸², total ignorance and a complete failure to take an interest in the running of a company, even by a director, will **not** end in liability for fraudulent trading. It is submitted however that this is certainly different for a professional rather than a lay director in a family company as were the facts in the above case.

Where there is a slight difficulty is when a defendant deliberately turns a blind eye in the hope that they will not be held liable for the part they play in the fraudulent trading. This category of knowledge is what is sometimes known as "Nelsonian blind-eye knowledge".

¹⁷⁹ [2005] BCC 739.

¹⁸⁰ Keay (n.43), 35.

¹⁸¹ For example as in *Re a Company (No. 001418 of 1988)* [1990] BCC 526, 531.

¹⁸² [1985] PCC 87.

Surprisingly, this issue was only recently addressed in *Morris v Bank of India*¹⁸³ in which both sides acceded to Patten J's finding that:

Knowledge includes deliberately shutting one's eyes to the obvious, provided that the fraudulent nature of the transactions did in fact appear obvious to those who dealt with these matters...at the relevant time. It is well established^[184] that it is no defence to say that one declined to ask questions, when the only reason for not doing so was an actual appreciation that the answers to those questions would be likely to disclose the existence of a fraud.¹⁸⁵

Therefore directors and other parties, such as the State Bank of India, who try and dodge liability by simply ignoring what is occurring in either their own or another company to which they are deemed to be "party to the carrying on of the business", cannot escape liability for fraudulent trading. One commentator was slightly alarmed at the unintended consequences that this might have¹⁸⁶ but as he did not elaborate on his concerns and no such consequences have arisen to date, it is submitted that these were slightly exaggerated.

Indeed, as Hart evinces¹⁸⁷, the Court of Appeal approved and elaborated on Patten J's judgement just over a year later¹⁸⁸ by setting out several factors which included:

- '-the importance and seniority of the agent or employee within the company structure...
- the significance and freedom of the agent or employee to act in the particular transaction...
- the degree to which the board is informed and put on inquiry.'¹⁸⁹

Such factors therefore serve to mitigate concerns about hindering the corporate behaviour of certain actors as well as usefully setting a guide which can then be followed- essential for preventing fraudulent trading behaviour from arising in the first place.

¹⁸³ [2004] 2 BCLC 236.

¹⁸⁴ Patten J then went on to cite Lord Scott's formulation of "blind-eye" knowledge in *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469, 517.

¹⁸⁵ *Ibid*, 243-244.

¹⁸⁶ S. Rajani, 'Fraudulent Financial Arrangements- Banks Beware!' (2006) 22 Tolley's Insolvency Law and Practice 103, 104.

¹⁸⁷ S. Hart, 'Extending the Directing Corporate Mind' (2005) 155 NLJ 1357.

¹⁸⁸ In *Morris v Bank of India* [2005] 2 BCLC 328.

¹⁸⁹ Hart (n.187), 1358.

2.4-Conclusion

Having traced and reflected upon the development of fraudulent trading and its bifurcation in 1985, it can be seen that the shared jurisprudential ancestry of the two provisions and a cross-over of caselaw has occurred both pre- and post-separation.

The degree to which this is problematic will be examined in the forthcoming chapter and then its significance will be evidenced in chapter four as there are further issues that arise from the evolution of these two provisions.

Its progression through the legislative process as a conceptual notion in corporate law (in the broadest sense) has significantly sped up in the last 60 years or so and this can be attributed to the great upward surge in the financial sector's importance to the Economy as well as the increased interest in and use of corporate governance.

The next chapter will analyse the provisions of the modern formulations of both civil and criminal law fraudulent trading provisions, yet given their exceptional closeness and near-identical wording, they will be dealt with side-by-side.

Chapter Three:

Evaluating Fraudulent Trading

3.1-Introduction

Having extracted several different issues from the preceding caselaw and identified a number of labyrinthine themes in relation to both s.993 of the Companies Act and s.213 of the Insolvency Act, it is now intended to analyse these areas much more closely.

3.2-The problematics of “intent to defraud”

It is submitted that the most prominent and immovable area of difficulty with the fraudulent trading concept *per se* is the critical phrase, “intent to defraud”¹. This is problematic, not only through the slight lack of consistency with which it has been applied since its inception, but also the very phrase itself is jurisprudentially dangerous in terms of plainly criminal law jurisprudence making its way into civil courts and then being applied with a lower burden of proof- that of “balance of probabilities” rather than “beyond reasonable doubt”. Indeed, Keay points out that there are no ostensible differences aside from procedure and the burden of proof between criminal and civil fraudulent trading².

Furthermore, elsewhere in Commonwealth jurisdictions³, a more onerous test is set out in order for criminal fraudulent trading to be proven through additional requirements to be made out rather than merely higher burdens of proof⁴.

3.2.1- Lack of consistent application

It is rather perplexing why, following both the Jenkins Committee in 1962 and the Cork Committee in 1982, that having recognised the difficulties and problems of s.332 of the Companies Act 1948⁵, nothing was done to resolve or suggest possible ameliorations to the phrase⁶.

¹ Insolvency Act 1986, s.213(1), Companies Act 2006, s.993(1) and their statutory antecedents.

² A. Keay, *Company Directors’ Responsibilities to Creditors* (Routledge-Cavendish, Abingdon 2007), 39.

³ Such as under Australia’s Corporations Act 2001, s.588G(3).

⁴ Keay (n.2), 39.

However, re-visiting the caselaw on the phrase as outlined above, two tentative observations can be made in the context of the application of the phrase in s.213 of the Insolvency Act 1986. It is submitted that Lord Hoffmann's holistic and subjective approach in *Aktieselskabet Dansk Skibsfinansiering v Brothers*⁷ is slightly too vague and nebulous to afford any real, effective protection (in a preventative sense) for creditors in the civil context. This is because determinations regarding the nature of a defendant's behaviour appear to be left to the whim and business awareness of the judge on the day.

As a corollary, it is submitted that legal certainty is desirable *per se* as it prevents liability from being retrospectively imposed through constant changes in the meaning and application of s.213 of the Insolvency Act (and s.993 of the Companies Act) in general. It also enables legal actors to know for definite what behaviour is proscribed and what is not so that they may conduct themselves accordingly.

Yet it must be recognised that there is potential for a tension to exist between such certainty and the effectiveness of any proposed test. With certainty comes the potential for those seeking to evade the regulation or legal rule to use bright line distinctions to their advantage. A prime instance for this is tax avoidance within taxation law where the very rigid rules of the Law are acknowledged but then simply eluded or circumvented.

Another example which very clearly shows this tension at work is the Law prohibiting directors from having conflicts of interest and making secret profits. The vast swathe of, arguably uncertain and at times confusing, caselaw was purportedly codified by s.175 of the Companies Act 2006⁸. This was a deliberate attempt to define and set out certain parameters of this directors' duty. However, it was also decided to then re-introduce the caselaw which s.175 had sought to clarify through s.170(4)⁹. This bizarre and almost nonsensical approach highlights the unease between bright line rigid rules and the need for some measure of flexibility.

However, it is submitted that in this instance, concerns over the rigidity of any potential rules defining liability for fraudulent trading are outweighed by other factors at play and certainty is a key part of any rule designed to regulate behaviour; arguably even more so in a financial or corporate setting. The avoidance of rules is a fact that must be accepted and may potentially be mitigated with

⁵ See [2.2.1].

⁶ Highlighted at [2.2].

⁷ [2001] 2 BCLC 324, 334.

⁸ Section 175(1) reads, 'A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.'

⁹ Which reads, 'The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.'

better enforcement and detection of those who flout them- this is especially relevant for s.993 of the Companies Act which, it will be strongly argued¹⁰, carries an even more important prophylactic effect than s.213 of the Insolvency Act for potential defendants will fear losing their liberty for up to ten years more than losing all their assets.

The second issue, as to what the correct nature and wording of the phrase should be, is not entirely straightforward either. There has clearly been a change of direction from a test on the factually-based ability of companies to repay debts¹¹ to one where defendants' minds must be more extensively examined in adopting, in the context of s.213, a holistic approach¹². The underlying emphasis on fraud and dishonesty based in criminal law is, it is contended, indicative of the great difficulty of formulating a test which must balance competing interests.

These interests, along with several other areas of corporate governance law¹³, must appropriately balance the needs and robust protection of creditors with those of commercial efficiency and transacting. In other words, companies ought to be neither laden down with over-zealous rules and regulations nor should they be given such a free reign so that they, and their directors and managers through them, conduct their affairs recklessly.

Indeed, as Maher and Forsyth highlight in their seminar paper¹⁴, Chadwick LJ in *Morphitis v Bernasconi*¹⁵ sought to deliberately ensure that s.213 was not so widely framed as to encapsulate all frauds perpetrated on creditors which Templeman J (as he then was) had suggested in *Re Gerald Cooper Chemicals*¹⁶. It is submitted that perhaps his Lordship was attempting to distinguish s.213 from s.993 of the Companies Act and move away from the criminal law jurisprudential heritage of "intent to defraud" given that the two provisions were by then firmly separated.

Therefore this raises the possibility that s.213 of the Insolvency Act (and its civil provision statutory ancestors) had been far too widely applied- with any sort of fraud on creditors coming under that section. It is contended, however, that this was not the case certainly pre-1985 separation of the provisions as both "intents" were one and the same for criminal and civil procedures. Furthermore, the post Insolvency Act 1986 caselaw has not, apart from *Morphitis*¹⁷, revisited this element in any detail. Though just after the civil provision's separation but before its move to the Insolvency Act

¹⁰ Below at [4.2.3].

¹¹ As in *Re William C. Leitch Brothers Ltd* [1932] 2 Ch 71, 77.

¹² As opined by Lord Hoffman in *Aktieselskabet Dansk Skibsfinansiering v Brothers*.

¹³ Such as that covering directors' duties.

¹⁴ M. Maher and J. Forsyth, 'Fraudulent Trading – An Under-Used Remedy' (13th April 2007) <http://www.guildhallchambers.co.uk/uploads/docs/section9/FraudulentTrading_AnUnder-usedRemedy_MM&JamesForsyth.pdf> accessed 3rd February 2011, para [6].

¹⁵ [2003] Ch 552, 576.

¹⁶ [1978] Ch 262, 267-268.

¹⁷ [1984] QB 675.

1986, it was reaffirmed according to older principles from *R v Grantham* in the case of *Re L Todd (Swanscombe) Ltd*¹⁸ which was brought under s.630 of the Companies Act 1985.

3.2.2- Subjectivity or clarity? An alternative potential formulation

As Keay eruditely points out in his excellent article¹⁹, there are two main issues surrounding the test of “intent to defraud”. First of all, is “intent” substantively objective or subjective and secondly, what standard of honesty is to be applied?²⁰

The test most certainly is subjective in its current formulation. However, it is submitted that greater guidance ought perhaps to be set out by the Courts, the Legislature or perhaps even an authoritative business body such as the Confederation of British Industry (C.B.I.) for this will ensure a greater normative and prophylactic effect for civil as well as criminal fraudulent trading.

An example of how this might function can be found in relation to directors’ duties. Despite the body of caselaw being so voluminous, principles can be distilled which then further serve to guide directors’ behaviour²¹. Furthermore, the Institute of Directors publishes guidance both online²² as well as in a definitive handbook²³. However, as mentioned above²⁴, directors’ duties also provide a case in point with regards to the need for a blend of both certainty and breadth as in any guide so as to avoid rules and legal maxims being flouted.

Perhaps therefore the very subjectivity of “intent to defraud” is in fact its main weakness. An alternative formulation might seek to reduce the influence of subjectivity whilst also being careful not to penalise business practice by being so regimented that normal managerial behaviour is restricted and stifled.

Clearly the interpretation and subsequent proof of “intent to defraud” is a rather intractable problem, but a suggested alternative which might improve the test on both counts is one based on “no reasonable director or person”. That is to say, something along the lines of,

¹⁸ [1990] BCC 125, 128.

¹⁹ A. Keay, ‘Fraudulent Trading: The Intent to Defraud Element’ (2006) 35 CLWR 121.

²⁰ Ibid, 125.

²¹ Publications such as P. Loose, M. Griffiths and D. Impey, *The Company Director: Powers, Duties and Liabilities* (11th edn, Jordan Publishing, Bristol 2011) and A. Keay and L. Kosmin (advisory ed), *Directors Duties* (Jordan Publishing, Bristol 2008) can often be found in the legal department of medium or large businesses.

²² In the form of a comprehensive set of guides, factsheets and briefings- Institute of Directors, ‘Business Information and Advice’ <<http://www.iod.com/Home/Business-Information-and-Advice/>> accessed 27th December 2010.

²³ M. Webster (ed), *The Director’s Handbook: Your Duties, Responsibilities and Liabilities* (3rd edn, Institute of Directors in association with Pinsent Masons and Kogan Page, London 2010).

²⁴ At [3.2.1].

“If no reasonable person in that position (if the fraudulent trading action relates to a creditor for example) could have believed what the defendant claims to believe, then the defendant will be deemed to have the requisite intent to defraud”

may well be a viable alternative.

Such a reasonableness-based formulation is not a new proposition and has been used in cases relating to the regulation of the behaviour of members of a company. In *Shuttleworth v Cox Brothers and Company*²⁵ for example, shareholders wanted to alter their company’s articles of association and this was then challenged. It was held *per* Bankes LJ that such shareholder conduct was to be tested and impugned if, “no reasonable men could consider it for the benefit of the company.”²⁶

Much more recently, this reasonableness-based test has been flipped onto its mirror-image; thus enabling defendants to evade liability where they acted reasonably in the circumstances. It was held in unfairly prejudicial conduct proceedings under s.994 of the Companies Act 2006, that if, “no reasonable director...could as a matter of commercial judgment have taken any course other than [that which the plaintiff was seeking to overturn]”²⁷, then this behaviour would not be penalised under s.994- even if there are slight procedural irregularities [sic]²⁸.

It is clear therefore that the “no reasonable director or person” test is applicable and indeed useful across a range of litigation whereby the behaviour of corporate actors is to be assessed. This extends to being both a sword to those seeking to take actions against corporate actors as well as a shield as this reasonableness formulation may be used to defend against such litigation. Why therefore should this test not be applied to fraudulent trading’s “intent to defraud”?

The test would take into account business considerations as *per Aktieselskabet Dansk Skibsfinansiering v Brothers*²⁹. It would also help clarify what has been shown to be a most intractable phrase whilst also allowing for changes in business practice and business morality. This is because each defendant’s behaviour would be examined alongside the “reasonable director or third party” **of the day’s** actions. It is therefore not retrospective in any way however, it is conceded that this does re-raise the issue of how the judiciary are supposed to effectively discern what no “reasonable director or third party” of the day would do.

²⁵ [1927] 2 KB 9.

²⁶ *Ibid*, 18.

²⁷ *Cobden Investments Ltd v RWM Langport Ltd* [2008] EWHC 2810 (Ch), [496].

²⁸ *Ibid*, [498].

²⁹ See [2.3.6] above.

The reason as to why the current formulation survives and still maintains a large degree of utility is because of the cross-pollination of “intent to defraud” from criminal to civil areas of the Law and back across again. It is contended that the breadth and almost nebulous nature of this terminology makes it much easier to use s.993 criminal fraudulent trading as a useful catch-all provision³⁰. Yet because of the shared jurisprudential history highlighted in chapter two, the uncertainty and subjectivity has remained in s.213 civil fraudulent trading too.

It is argued that unlike other civil provisions such as directors’ duties or wrongful trading which are more or partially objective in their assessment of a defendant’s behaviour, the vagueness of fraudulent trading under s.213 Insolvency Act 1986 is undesirable.

3.2.3-The “burden” of proof and the nature of s.213 actions

Section 213’s sister fraudulent trading provision has a higher burden of proof. For a conviction under s.993 of the Companies Act 2006, as in all criminal proceedings, the defendant’s guilt must be proven beyond reasonable doubt. Section 213 actions meanwhile must be proven on the civil law balance of probabilities.

It is this disparity that is a root cause of the tension between “intent to defraud” and the fact that because civil fraudulent trading has been decisively hived off from the criminal provision, it is therefore potentially free to break from its legislative history- although this would be far easier said than done.

One might consider that the issue here centres specifically around a lower “balance of probabilities” burden of proof being used to decide an ostensibly criminal law issue in civil courtrooms, but this albeit logical conclusion must be partially rejected. Instead, the paradoxical opposite is occurring in part and Griffin’s observation that the s.213, ‘standard of proof may be adjudged to be **more** akin to the criminal standard of proof’³¹ illuminates the problem clearly and precisely. Note that it is “more akin” and not merely “akin” which points to the existence in s.213 fraudulent trading of a half-way standard which is not quite that required by the criminal law, but is greater than the ordinary balance of probabilities.

The problem is thus two-fold. Firstly, it is inappropriate that fraudulent behaviour is being tested to this civil, albeit in reality higher than balance of probabilities standard; for it is ostensibly a criminal

³⁰ Highlighted below in terms of procedural utility at [4.3].

³¹ S. Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing, Oxford 1999), 42 [emphasis added].

law concept incorporating *Ghosh* dishonesty. Secondly, the efficacy of s.213 is constantly being hamstrung to meet this phantom “higher but not quite criminal” burden of proof because of the nature of its jurisprudential history with imported criminal law conceptions.

Indeed, as the Cork Report highlighted, the “deliberate dishonesty” which must be proven strongly deters proceedings from being issued in civil courts even, ‘where a strong case has existed for recovering compensation from the directors or others involved.’³²

On the other side of the problem is the disparity between burdens of proof and this separately raises the issue of what could be termed “slipstreaming”. That is to say that because the criminal law burden of proof is higher, it is therefore inevitable that a successful s.993 prosecution, *ceteris paribus*, will also entail success under s.213 Insolvency Act proceedings. A liquidator then effectively enters the slipstream of the s.993 proceedings which will save them an awful lot of time and money— even more so as the putative defendants would pragmatically not even bother to defend a s.213 action in this situation. Indeed, there is nothing to procedurally stop liquidators from doing just this very thing³³.

However, the issue lies in the fact that this does not work the other way around as the practitioners’ text *Arlidge and Parry On Fraud* highlights³⁴ because *per* Mummery LJ in *Bank of India v Morris*³⁵, ‘the severing of criminal and civil liability for fraudulent trading means that there is no question of any conclusion, in principle or on particular facts, as to civil liability affecting the basis on which criminal liability is assessed.’³⁶

Yet clearly if a finding of guilt in a s.993 criminal prosecution were to occur, then the finding of s.213 civil liability would surely be academic and almost merely procedural as criminal fraudulent trading is proven to the much higher “beyond reasonable doubt” standard. It therefore seems slightly illogical to allow civil proceedings to slip-stream criminal proceedings, but then to disallow publicly-funded criminal proceedings doing the same in reverse.

³² Review Committee, *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558, 1982), 398-399.

³³ Keay (n.2), 39. Most notably, criminal convictions are admissible as evidence in civil trials pursuant to the Civil Evidence Act 1968, s.11.

³⁴ J. Parry *et alii*, *Arlidge and Parry On Fraud* (3rd edn, Sweet & Maxwell, London 2007), [8-005].

³⁵ [2005] BCC 739.

³⁶ *Ibid*, 766.

3.3-Other restrictions of the wording of fraudulent trading which influence its effectiveness and efficacy

3.3.1- The effect of the “in the course of winding up” limitation

The phrase “in the course of winding up” was a part of the dual fraudulent trading provision which, as set out in the previous chapter³⁷, was challenged unsuccessfully in the House of Lords in *DPP v Schildkamp*³⁸ as far as criminal proceedings under s.332(3) of the Companies Act 1948 were concerned. This then prompted the enactment of s.96 of the Companies Act 1981 which reversed the decision in that, under criminal fraudulent trading proceedings, there was no longer a requirement that the company had been or was in the course of being wound up.

This therefore, it is contended, gives s.993 an enviable advantage over its Insolvency Act sibling for putative defendants can be stopped in their tracks as and when they commit their behaviour defrauding creditors. Under s.213 of the Insolvency Act, liquidators have no choice but to commence winding up- even though this may not be the best financial option for a company and administratively this can take weeks to process. This is because a court order³⁹ is required if members do not voluntarily wind up the company first (though naturally they are unlikely to if some members are aware this might expose them to s.213 Insolvency Act liability). Indeed, it has been argued that s.213 ought to be widened to match s.993 of the Companies Act and a central argument put forward for this proposition is that a company may **only** be trading and not threatened with being wound up due to the fraudulent trading activity propping it up financially⁴⁰.

However, it is contended that whilst companies might be able to conceal their genuine financial position from creditors by using funds from one to pay the interest or debts they owe to another- a classic example of “robbing Peter to pay Paul”, this will not *per se* overcome the problem of discovering the behaviour in the first place.

If a creditor discovers that fraudulent trading is occurring, they can call a meeting to wind up the company⁴¹ but can only begin the process of winding up if they obtain the agreement of a members’ meeting. Alternatively, creditors can apply to the Courts under powers in s.124 of the Insolvency Act

³⁷ [2.2.3].

³⁸ [1971] AC 1.

³⁹ Insolvency Act 1986, part IV, chapter VI.

⁴⁰ R.C. Williams, ‘Fraudulent Trading’ (1986) 4 Company & Securities Law Journal 14.

⁴¹ Insolvency Act 1986, part IV, chapter IV.

1986 to have the company wound up on the grounds that that it is unable to pay its debts⁴² and/or it would be just and equitable to do so⁴³.

What Williams' suggestions highlight are the difficulties (with both fraudulent trading provisions) of discovery. If behaviour is not discovered, then nothing can be done about it. Yet the actual process for stopping the errant behaviour is somewhat long-winded as far as the civil process is concerned. It is true that criminal fraudulent trading suffers from the same discovery problems, however it is crucially different in that the errant behaviour can be stopped almost immediately with the Police and Serious Fraud Office both able to arrest and detain individuals as well as preventing the company from trading with near-immediacy.

Even if individuals are arrested merely on suspicion and there is not yet enough evidence to charge them at that moment, it is submitted that this will have a shock factor which will prevent them from carrying on business in their illegal manner any further. Indeed, this shock factor can be directly attributed to the severity of punishment under s.993.

3.3.2- Solely liquidators having *locus standi* to bring s.213 Insolvency Act actions.

In mentioning the difficulties faced by liquidators in proving and making out s.213 claims, it must be pointed out that, unlike many other civil actions, a s.213 (or s.214) action cannot be sold or transferred to another party. As *Palmer's Company Law* makes plain, the statutory legal basis of the provisions under the Insolvency Act 1986 and the fact they give *locus standi* to only the liquidator, prevents liquidators from doing so. Furthermore, the Law of Champerty also imposes restrictions which mean that only the liquidator may bring the action⁴⁴.

There is however an important distinction to be made. As held most recently in *Ruttle Plant Hire Ltd v Secretary of State for the Environment, Food and Rural Affairs*⁴⁵, the **fruits** of a s.213/4 action may be assigned by the liquidator but the right to bring or carry on proceedings is not assignable.

Ramsey J provided a very clear and concise explanation of the Law⁴⁶ but was careful to allow the Courts to set aside assignments of the fruits of actions if a court were to, 'find the means of funding or payment objectionable on public policy grounds'⁴⁷.

⁴² Ibid, s.122(1)(f); see also s.123 for the meaning of "unable to pay its debts".

⁴³ Ibid, s.122(1)(g).

⁴⁴ G. Morse (ed), *Palmer's Company Law* (Looseleaf Sweet & Maxwell, London), [15.599.36].

⁴⁵ [2008] EWHC 238 (TCC), [45]-[46].

⁴⁶ Ibid, [44]-[56].

⁴⁷ Ibid, [55]. Yet precisely what such grounds might be is not clear and open to general interpretation.

However, he also reiterated the main thrust of his judgement; ‘that it is difficult to see that the element of funding in itself necessarily renders the exercise of the otherwise valid statutory sale objectionable.’⁴⁸

Pertinently in *Re Oasis Merchandising Services Ltd*⁴⁹, a s.214 case, Robert Walker J rejected the defendant directors’ application to stay proceedings due to the liquidator assigning assets gained to a specialist liquidation support company⁵⁰ (a rejection subsequently approved on appeal⁵¹).

Prima facie, this could give ‘the green light’ to large, powerful creditors encouraging liquidators to undertake s.213 actions by offering them funds or a security if they do not succeed and in return being assigned a large slice of the fruits of a fraudulent (or wrongful) trading action. Yet in practice, this situation has hardly arisen. It is argued that this is because under ss.165(6) and 167(2) of the Insolvency Act 1986, a liquidator is obliged to give notice of such activity to the liquidation committee if there is one. Failing this, the liquidator’s assignment of the fruits of an action, ‘is subject to the control of the court, and **any creditor or contributory may apply to the court with respect to any exercise or proposed exercise of any of those powers.**’⁵² Relevant interested parties can therefore keep such creditors’ attempts at bay.

What can be discerned from this peculiarity is that there is a clear policy-driven desire to prevent liquidators from transferring s.213 actions to other parties. This comes in the form of Parliament’s wish for only liquidators to be afforded *locus standi* under s.213 itself. In addition, there may also be an underlying or subliminal common law presumption in the form of the maxims to be found in the Law of Champerty which indirectly serve to reinforce the exclusivity of liquidators as plaintiffs under s.213.

The notion of the fruits of an action, rather than the action itself being assignable could, it is submitted, be tentatively regarded as an attempt to get around the “liquidators only” issue. Though this practice has very rarely occurred- perhaps not only to do with the procedural checks and balances as mentioned above⁵³, but also because creditors which purchase the fruits may fear that they lack control to ensure that the liquidator undertakes the action with sufficient vigour and so their “fruit basket” (to adopt a metaphor) may not be as full as they would have liked.

⁴⁸ Ibid.

⁴⁹ [1995] BCC 911.

⁵⁰ Ibid, 920.

⁵¹ [1998] Ch 170, 186.

⁵² *Per* the Insolvency Act 1986, s.167(3)- [emphasis added].

⁵³ At [2.3.7].

Setting aside criminal fraudulent trading provisions, the relatively recent⁵⁴ notion of excluding other creditors and other contributories from bringing actions under s.213 of the Insolvency Act raises the obvious question of “why?”.

Giving back creditors and contributories their right to begin s.213 actions naturally creates a much wider class of potential plaintiffs which, as Keay points out⁵⁵, raises the possibilities of both a mass of new litigation and double-litigation against directors and other putative defendants. Furthermore, the powerful creditor and “common pool problem” issues re-arise in that a main creditor with a great deal of resources could (perhaps slightly speculatively) bring a s.213 action and recoup all of their losses; leaving no assets behind for other creditors. This same problem is also mirrored in proceedings which might be brought for the tort of deceit⁵⁶. Therefore, it is submitted that issues of fairness and equitable division of assets are the key rationales behind preventing creditors from bringing s.213 actions by themselves. A *pari passu* distribution of assets does not necessarily disadvantage the large creditor who would be the sort to bring a s.213 action by themselves, for the larger creditors would have a larger claim to the “assets pot” given that claims are divided up on a *pro rata* basis.

However it has been noted that in other Common Law jurisdictions, such as Singapore and South Africa, creditors may still bring fraudulent trading proceedings whereby crucially, if they are successful, the recovered assets are distributed *pari passu*⁵⁷. Though this once again returns us back to a derivative action-esque dilemma in which creditors are unlikely to bother at all unless they get all of that which they are owed or a larger slice of the assets that are recovered. In Australia, directors are liable under s.588G of the Corporations Act 2001 but creditors may themselves bring actions only with the permission of the liquidator⁵⁸. It must be noted however that creditors in that jurisdiction may bring actions **prior** to a company being wound up⁵⁹.

It must be highlighted that liquidators can be remunerated for their work in three different fixed ways and their remuneration is explicitly set in priority to all other claims on an insolvent company’s assets upon liquidation⁶⁰. These three ways are:

(a) as a percentage of the value of the assets which are realised or distributed, or of the one value and the other in combination, or

⁵⁴ Since the Insolvency Act 1986.

⁵⁵ Keay (n.2), 67.

⁵⁶ As mentioned at the start of this thesis at [1.1].

⁵⁷ Keay (n.2), 66.

⁵⁸ Corporations Act 2001 (Australia), s.588M.

⁵⁹ See R.P. Austin and I.M. Ramsay, *Ford’s Principles of Corporations Law* (13th edn, Lexis Nexis, Chatswood Australia 2007), 973.

⁶⁰ Insolvency Act 1986, s.115 and s.176ZA(4).

(b) by reference to the time properly given by the insolvency practitioner (as liquidator) and his staff in attending to matters arising in the winding up, or

(c) as a set amount⁶¹.

As a matter of insolvency procedure, the choice of method of remuneration is fixed by the liquidation committee⁶² or if there is not one, by a resolution at a creditors' meeting⁶³ - both of which have a very wide range of discretion⁶⁴.

It is this third method that attracts the most interest. It is a very recent addition⁶⁵ and only came into effect on the 6th April 2010. Therefore, it might at first appear that because of the introduction of the availability of fixed fee remuneration arrangements for liquidators, the frequency of s.213 (and indeed s.214) actions will decrease given that liquidators are, *prima facie*, not going to get any more fees if they begin s.213 proceedings.

Yet, my own casual empiricism (based on time spent in the corporate recovery departments of City solicitors during vacation schemes⁶⁶), suggests that conditional fee arrangements for liquidators are now increasingly the norm⁶⁷. They are negotiated along "no win, no fee" type terms, yet can be easily amended and tailored to what the client's requirements are. This includes provisions regarding pursuing third parties which may be done solely under s.213.

However, with wider use of such fixed fees remuneration and greater accountability to creditors due to altered procedures for challenging expenses⁶⁸, liquidators are arguably not all that less likely to begin fraudulent trading actions. It is market forces which will determine the average fixed fee and frequency of conditional fee arrangements where issues of fraudulent trading arise.

Therefore the profession's main journal publication *Recovery*⁶⁹ (sent out to all members of the leading professional association for insolvency practitioners) which a few years ago cautioned against taking s.213 actions⁷⁰, may now take a rather different stance.

⁶¹ According to The Insolvency (Amendment) Rules 2010, SI 2010/686, sch.1, [217(2)(c)].

⁶² Ibid, Rule 4.127(3).

⁶³ Ibid, Rule 4.127(5).

⁶⁴ Ibid, Rules 4.127(3A)-(4).

⁶⁵ *Per* The Insolvency Rules 1986, SI 1986/1925 (as amended), Rule 4.127(2)- see Rules 4.127-4.127B for further elaboration.

⁶⁶ In DLA Piper and Dechert and also Gateley's in Birmingham.

⁶⁷ Unfortunately, I have not been able to find any more robust empirical data identifying how common these arrangements are as law firms are under no obligation to disclose the types of fee arrangements they agree.

⁶⁸ S. Leinster, 'Modernisation Changes Coming Soon To Insolvency Legislation' [2010] *Recovery* 28, 28.

⁶⁹ Back issues may be found online at:

<<https://www.r3.org.uk/publications/default.asp?dir=recovery&pag=backissues&i=330>> accessed 14th December 2010.

3.4-The effects of (non)punishment

3.4.1- Section 213- taking away the punishment

It is submitted that fraudulent trading, since its inception, has had a dual purpose; both to recover assets for creditors but also, importantly, to punish those who fail to devoid themselves of the proscribed behaviour. This explains why the criminal law element has featured in subsection (3) throughout the life of the dual provision until its bifurcation in 1985⁷¹. Indeed, right up until *Morphitis v Bernasconi* s.213 was strongly punitive and received judicial mention and approval of being so⁷².

Furthermore there has been and still is another noteworthy element of punishment which also protects the corporate community- disqualification. Right from the outset⁷³, those found liable or guilty under the fraudulent trading provision were also potentially prevented from running a company as a director. This still holds true today under the Company Directors Disqualification Act 1986⁷⁴ and is an important part of the regulation of those who run companies.

Of note is that Dine, in her review of wrongful and fraudulent trading and the director disqualification regime, draws some very close comparisons between disqualification and criminal punishment⁷⁵. In fact, it is this likeness which she argues inappropriately erodes the rights of those subject to these proceedings. It is also noteworthy that she is dealing with the disqualification as a concept *per se*, rather than the consequences of breaching disqualification orders and undertakings which does result in criminal offending⁷⁶.

This therefore inexorably raises the question of whether fraudulent trading is *per se* in need of having a punitive approach taken towards those who transgress its provisions (both criminal and civil). It is strongly argued that dealing punitively with those found guilty or liable under either fraudulent trading provision is necessary as it serves two important functions.

The first is one of prophylaxis and preventing other instances of fraudulent trading occurring and the second is slightly less obvious in that it has a slight, albeit important, retributive effect. To cite Lord

⁷⁰ For example S. Adair, 'Applications Under Section 213 of the Insolvency Act 1986' [2008] Recovery 28, 29.

⁷¹ See [2.2.1].

⁷² *Re a Company (No. 001418 of 1988)* [1990] BCC 526, 531-532.

⁷³ Companies Act 1928, s.75(4).

⁷⁴ Sections 4 and 6.

⁷⁵ J. Dine, 'Punishing Directors' [1994] JBL 325, 331-332.

⁷⁶ Under the Company Directors Disqualification Act 1986, s.13. See also M. Stockdale and R. Mitchell, 'Disqualification, Confiscation Orders and Piercing the Corporate Veil in Criminal Proceedings' (2010) 31 Company Lawyer 383 and S. Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing, Oxford 1999).

Hewart CJ's famous maxim, 'justice should not only be done, but should ... be seen to be done.'⁷⁷ and punishment in terms of imprisonment and/or damages (recovered via the Proceeds of Crime Act 2002 procedure or compensation orders) will not undo or fully reimburse the creditors' losses suffered, but will perhaps bring them some intangible comfort.

However, since the decision of *Morphitis v Bernasconi*, punitive damages under s.213 of the Insolvency Act are no longer permitted⁷⁸; thus ostensibly reducing the retributive and more importantly the deterrent effect of s.213. Clearly if a defendant is held liable for damages greater than merely those assets owed to creditors, they are logically much less likely to commit fraudulent trading in the first instance.

Morphitis v Bernasconi is not controversial if one takes a holistic view of civil law damages whose purpose is to put the plaintiff in the position they would have been had the wrong not occurred⁷⁹ and there are very few exceptions to this⁸⁰. Other Common Law jurisdictions however take a different view. In Australia for example, as *Ford's Principles of Corporations Law* superbly enunciates⁸¹, where a director has contravened the fraudulent trading provision⁸², the Courts may make civil orders (notwithstanding a director's criminal liability under the same section) by first making a "declaration of contravention". They can then make subsequent orders including disqualification of the director⁸³, a compensation order⁸⁴ and/or a pecuniary penalty order up to a maximum of A\$200, 000⁸⁵ (equivalent to around £130,000). The Australian legal system takes the view that such punitive damages are required where the plaintiff's rights have been disregarded and they also act as a strong deterrent⁸⁶.

However what makes the *Morphitis* decision somewhat surprising, as Jones eruditely points out⁸⁷, is that it directly contradicts previous caselaw. This includes *Re William C. Leitch Brothers Ltd*⁸⁸, *Re Cyona Distributors Ltd*⁸⁹ and *Re a Company (No. 001418 of 1988)*⁹⁰ which, given the scarcity of reported s.213 decisions is very significant. Indeed, the decisions stretch across the entire life span

⁷⁷ *R v Sussex Justices Ex parte McCarthy* [1924] 1 KB 256, 259.

⁷⁸ (n.15), 579-580.

⁷⁹ *Attorney General v Blake* [2001] 1 AC 268, 296-298.

⁸⁰ See for example J. Murphy, 'The Nature and Domain of Aggravated Damages' (2010) 69 CLJ 353.

⁸¹ R.P. Austin and I.M. Ramsay (n.60), 969-974.

⁸² Corporations Act 2001 (Australia), s.588G.

⁸³ *Ibid*, s.206C.

⁸⁴ *Ibid*, ss.588J, 588M and 1317H. N.B. compensation orders can also be made in criminal proceedings for fraudulent trading, under s.588K for example.

⁸⁵ Under *ibid*, s.1317G.

⁸⁶ R.P. Austin and I.M. Ramsay (n.60), 833.

⁸⁷ B. Jones, 'Case Comment: The Difficulty of Proving Fraudulent Trading' [2003] *Insolvency Intelligence* 69.

⁸⁸ [1932] 2 Ch 71.

⁸⁹ [1967] Ch 889.

⁹⁰ [1991] BCLC 197.

of the fraudulent trading provision and the Deputy Judge of the High Court in *Morphitis* at first instance understandably followed this set precedent and set the punitive element of the awarded damages at £17, 500⁹¹.

Yet, the decisive factor for Chadwick LJ in overriding the long line of precedent in the Court of Appeal was the fact that Parliament had re-enacted the criminal sanction for fraudulent trading in what was then s.458 of the Companies Act 1985. This leads to the conclusion that Parliament's intent was that s.458 of the Companies Act and not s.213 civil fraudulent trading under the Insolvency Act was to be used to punish defendants and the power of the former could not be used to order punitive damages under the latter⁹².

This then raises the question of what s.213 is therefore for. However it is unassailably clear that damages under s.213 are restricted to reflecting creditors' losses (i.e. the assets they should have received during winding up) but for the fraudulent trading⁹³. This has been subsequently approved⁹⁴ despite the fact that an award under s.213 may only be, 'a reasonable approximation to the damage' caused by or contributed to by the defendant(s) as well as having elements of calculation which, 'will inevitably be broad-brush'⁹⁵. Therefore the abhorrence towards pre-*Morphitis*-esque damages can be clearly seen to be concentrated on the fact that their nature was punitive, rather than their potential to be unpredictable or arbitrary.

3.5-Conclusion

Having dissected the different statutory requirements of section 213 in chapter 2, and the Courts' interpretation of those requirements, this chapter has turned to evaluating the legal picture that chapter 2 painted. Thus, the restrictions which s.213 civil fraudulent trading imposes on creditors have also been looked at and commented on as these are an important area of contrast between that civil law provision and other remedies potentially available to them. Also in this chapter, the problems which the shared jurisprudential history of both s.213 of the Insolvency Act and s.993 of the Companies Act have been identified and enunciated.

It has been shown that problems arise out of the imports of criminal law jurisprudence- especially surrounding the "intent to defraud" element. This, along with the "in the course of winding up"

⁹¹ *Morphitis v Bernasconi* [2001] 2 BCLC 1, 46.

⁹² (n.15), 579.

⁹³ — —, 'Case Comment: *Morphitis v Bernasconi*: No Punitive Element In Contribution For Fraudulent Trading' [2003] Company Law Newsletter 8 and Morse (ed) (n.45), [15.599.24].

⁹⁴ *In Re Bank of Credit and Commerce International SA & Anor* [2004] BCC 404.

⁹⁵ *Ibid*, 461.

phrase present in the civil but not in the criminal provision for fraudulent trading in particular have highlighted the contrasts between the two sides of the same legal coin.

Yet this coin, it has been proposed, is weighted more favourably towards s.993 of the Companies Act and in the next chapter the contrasts and differences between the criminal and civil provisions will be demonstrated and picked out as both fraudulent trading provisions are compared in practical as well as jurisprudential terms.

Chapter Four:

s.993 of the Companies Act 2006 and

s.213 of the Insolvency Act 1986- A Comparison

4.1-Outline

Having undertaken a thorough analysis of the shared history¹ and jurisprudence² of civil and criminal fraudulent trading provisions, a comparison can now more easily be made between them. In this chapter, evaluations and contrasts will be made and highlighted; drawing both upon practical as well as jurisprudential bases.

It will be posited that, in the final analysis, s.993 of the Companies Act has a much more far-reaching prophylactic effect and is better at policing fraudulent trading behaviour. In practical terms, s.993 is undoubtedly superior to civil fraudulent trading because of its ability to adapt and utilise the very powerful provisions of the compensation order regime³ as well as its much wider scope in terms of both covering non-company entities and being used before companies are wound up.

Yet, it has a slight *caveat* as it can be devoid of easy and quick remedies for creditors who may find it hard to recover assets as the post-conviction procedures can be complex. In this instance, its sister provision of s.213 of the Insolvency Act comes into its own. Despite the shared legal ancestry of the two provisions, it must be highlighted that ostensibly criminal law concepts are being applied inappropriately in civil courts.

In the ensuing chapter a comparison and critique of the two provisions side-by-side will be undertaken and conclusions reached about their respective suitabilities as instruments to protect creditors and recoup their assets.

¹ See chapter 2.

² See chapter 3.

³ See generally A.N. Brown (annotator), *Proceeds of Crime* (Greens Essential Legislation Series, W. Green & Son Ltd 2004) and E. Rees, R. Fisher and P. Bogan, *Blackstone's Guide to the Proceeds of Crime Act 2002* (3rd edn, OUP 2008).

4.2-Jurisprudential comparisons

4.2.1- Summary

It has been demonstrated⁴ that the two provisions share a jurisprudential history and cross-incorporate principles from different sides of the civil:criminal law divide. This was and still is the case since the two provisions were bifurcated under the Companies Act 1985.

It was Lord Steyn in the case of *R v Hinks*⁵ who opined that, ‘The purposes of the civil law and the criminal law are somewhat different. In theory the two systems should be in perfect harmony.’⁶ Yet, the key problem for fraudulent trading is the extreme closeness of both civil and criminal law provisions as well as their shared jurisprudential heritage which has seen the two elements split only fairly recently. This contrasts starkly for example to theft and the tort of conversion which share neither aspects in common. Indeed, as evinced above⁷ the Greene Committee, the body responsible for drawing up the original provisions for fraudulent trading, perhaps rather tellingly used the word “guilty” when discussing both civil and criminal liability in their recommendations.

It is contended that the use of civil processes for fraudulent trading is inappropriate for it forces concepts evidently firmly rooted in the criminal law into the civil law arena. This is not entirely objectionable *per se* but it is primarily the caselaw surrounding the phrase “intent to defraud” which was especially difficult to interpret in a civil law context right from the outset⁸ which makes this cross-pollination undesirable and disagreeable. Indeed, it is not only in the civil context where difficulty has arisen, for the phrase precipitated the very unusual judicially mandated alteration of the procedural work of authority in criminal law *Archbold* in *R v Peter Nevill Cox*⁹.

As Farrell, Yeo and Ladenburg poignantly and tellingly underline, ‘the offence of fraudulent trading ha[s] changed from its inception into a general fraud offence’¹⁰ and it is this fact that renders the application of cross-jurisprudence to s.213 of the Insolvency Act both unsuitable and inappropriate.

Furthermore, the semantics of the phrase all point to criminality¹¹ and it is strongly contended that the entire flavour of the phrase “intent to defraud” connotes a state of mind better suited to criminal

⁴ At [2.2].

⁵ [2001] 2 AC 241.

⁶ *Ibid*, 252.

⁷ At [2.2.1].

⁸ A. Keay, ‘Fraudulent Trading: The Intent to Defraud Element’ (2006) 35 CLWR 121, 122-123.

⁹ (1982) 75 Cr App R 291, 296.

¹⁰ S. Farrell, N. Yeo and G. Ladenburg, *Blackstone’s Guide To The Fraud Act 2006* (OUP, Oxford 2007), 75.

¹¹ A. Keay, *Company Directors’ Responsibilities to Creditors* (Routledge-Cavendish, Abingdon 2007), 52.

courts and arbitrators of fact much more used to dealing with questions of *mens rea* and therefore better able to discern a defendant's culpability.

The *Ghosh* element of dishonesty as well as other characteristics imported from general fraud and dishonesty offences have irrevocably tainted s.213 due to its jurisprudential heritage. Indeed, Slapper and Tombs warn against treating "fraud" as a homogenous category in their examination of the theory of corporate crime¹² - yet standards from theft, conspiracy to defraud and various other offences have been imported.

Of further importance to note is the issue of burdens of proof and the arguments set out and rehearsed in the previous chapter highlighted the only slightly asymmetrical nature of proof for what is *prima facie* the same wrong. Yet, when taken to two separate types of court dealing with entirely different procedures and bodies of law, there is significant overlap which leads to distorted standards of proof.

Indeed, it was issues with burdens of proof that partially led to the Cork Report's recommendation that civil fraudulent trading should not have proceeded to being re-enacted under the Companies Act 1985 (and then from there into the Insolvency Act 1986)¹³.

Another crucial difference between the two provisions is of course the fact that "in the course of winding up" is present in s.213 but is deliberately and unequivocally omitted in criminal fraudulent trading *per* s.993(2) of the Companies Act 2006. This is a major gulf between the net of liability which each provision casts and it therefore diminishes the former's effectiveness when compared to the more far-reaching remedy of criminal fraudulent trading.

4.2.2- "intent to defraud"- a criminal law bedrock to a civil law castle made of sand?

It has been shown¹⁴ that the notion of "intent to defraud" passed seamlessly into usage for civil fraudulent trading. Whilst understandable when both criminal and civil provisions were conjoined under the same statutory section, the phrase's persistence in s.213 of the Insolvency Act 1986 is lamentable as it remains despite the Cork Committee explicitly suggesting its removal¹⁵ and, more pertinently, the criminal law jurisprudence which it incorporates.

¹² G. Slapper and S. Tombs, *Corporate Crime* (Pearson Education Limited, Harlow 1999), 88.

¹³ See [3.2.3].

¹⁴ At [2.3.4].

¹⁵ Review Committee, *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558, 1982), 399.

As highlighted already, the concept of dishonesty which is now all-too-prevalent in s.213 civil fraudulent trading was intended to be applicable to the criminal element of the dual provision as it then was¹⁶. Yet, as Parry *et alii* point out, fraudulent trading is now one of a number of offences including conspiracy to defraud (and forgery until the Forgery and Counterfeiting Act 1981), 'defined in terms of the common law concept of fraud...and dishonesty is an element of these offences too. It means the same in every case.'¹⁷

Of further concern is that the actual test for dishonesty which applies to both civil and criminal provisions is (and still is) that of *Ghosh* dishonesty- a test itself not without criticism as Herring points out¹⁸. *Prima facie* this would be entirely acceptable and jurisprudentially prudent as it imposes a subjective standard on those putatively liable under s.213 or s.993. However, the fact that the case of *R v Ghosh*¹⁹ was one of deception of different kinds- now abolished under the Fraud Act 2006²⁰ is of importance as these are criminal law only provisions. Civil actions which might be analogous, such as the tort of deceit, are based on different factors- not ones drawn from the criminal law.

Why then were criminal law-only standards of dishonesty being applied to civil law measures? The answer is plain in that **prior** to the Companies Act 1985 separation of civil and criminal fraudulent trading provisions, the two were based on the very same "intent to defraud" found in subsection (1) of whichever dual provision one cares to look at. If Parliament had intended them to have separate considerations for each "intent to defraud", depending on what type of court they were being put forward in, then it would have enacted so.

Indeed, as Keay highlights, the Australian version of these two provisions are set out akin to pre-1985 Companies Act separation, but for criminal liability to be established, extra requirements must be met before this type of liability is imposed in Australian courts²¹.

Therefore it would have been possible and indeed practicable to legislatively add extra requirements to meet a higher standard of behaviour for criminal rather than civil fraudulent trading. Yet it can be gleaned from both the widening of the criminal offence under s.9 of the Fraud Act 2006, from the fact that the "in the course of winding up" requirement was removed and from the general

¹⁶ *R v Peter Nevill Cox* (1982) 75 Cr App R 291, 296 and see [2.3.4].

¹⁷ J. Parry *et alii*, *Arlidge and Parry On Fraud* (3rd edn, Sweet & Maxwell, London 2007), 5 and fn. 1.

¹⁸ J. Herring, *Great Debates: Criminal Law* (Palgrave Macmillan, Houndmills 2009), 151-158.

¹⁹ [1982] QB 1053.

²⁰ Fraud Act 2006, Schedule 3, para. [1].

²¹ Keay (n.8), *ibid*.

legislative mood in recent times²² that the Government wanted to widen and not narrow the scope of criminal liability for fraudulent trading.

This therefore begs the question as to whether it is appropriate for civil burdens of proof to be used when criminal language and concepts are so heavily embedded in fraudulent trading.

Furthermore, if one semantically examines the phrase “fraudulent trading” or “intent to defraud” then the man on the Clapham omnibus would, it is contended, ordinarily place these two phrases within the realm of the criminal law because the notion of fraud is a plainly criminal one. Indeed, each and every reference to “fraud” in the Insolvency Act 1986 (of which there are some 60) deals with criminal offences and matters pertaining thereto except for s.213 and s.423 which empowers courts to set aside transactions defrauding creditors²³ - something not possible in the criminal law domain even under Proceeds of Crime Act legislation and whose roots can be traced back to 16th century bankruptcy laws according to Finch²⁴.

Furthermore, this very close nexus between the fraudulent trading concept and the criminal law has hugely advantageous practical implications for s.993 fraudulent trading as Farrell, Yeo and Ladenburg point out. They establish this by drawing close parallels with conspiracy to defraud and highlighting the immense width of criminal fraudulent trading and the fact that it, ‘may be adapted to increasingly sophisticated fraudulent mechanisms.’²⁵ This practicality and immense utility is certainly true if one looks at the earliest types of fraudulent trading such as first, *Re William C. Leitch Brothers Ltd*²⁶ where a company continued to order goods on credit when it was in a dire financial situation with virtually no hope that creditors would ever be paid. This contrasts with *R v Leaf*²⁷ for example which was a far more multifaceted and complex fraud involving tax avoidance where companies with large tax bills were purchased and then their tax liabilities were fraudulently reduced through complex false loans and transactions- with the difference then being pocketed.

One potential explanation as to the blurring of criminal and civil wrongs involving fraudulent behaviour is offered by Page, in her excellent article on the concept of fraud. She evidences that fraud is an immature crime which is why there can be some sympathy towards the view that it is not truly a “proper” crime as say theft is²⁸. Her article was written before the recent swathe of legislation

²² Such as the introduction of the Bribery Act 2010.

²³ See for example *Giles v Rhind (No 2)* [2009] Ch 191 and *Sands v Clitheroe* [2006] BPIR 1000.

²⁴ V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP, Cambridge 2009), 578.

²⁵ Farrell, Yeo and Ladenburg (n.10), 82.

²⁶ [1932] 2 Ch 71.

²⁷ [2008] 1 Cr App R (S) 3.

²⁸ F. Page, ‘What Is Fraud?’ (1997) 147 NLJ 321.

designed to bring white collar crime under much harsher penal regimes and regulation and this approach has been robustly backed up by the Courts²⁹.

4.2.3- The case for crime

Having pointed out the distinctive criminal law flavour of fraudulent trading, especially the required mindset of an “intent[ion] to defraud”, the case for sole criminalisation of fraudulent trading will be examined. The following section takes a solely jurisprudential approach and excludes practical considerations such as the fact that criminal attempts can be prosecuted³⁰ and that compensation orders can be used by creditors to recover losses- these will be considered later below³¹. It will be argued that as “intent to defraud” does not sit well jurisprudentially within s.213 civil fraudulent trading, it should perhaps be either clarified or edited by Parliament³². These possibilities will be looked at in the final chapter of this thesis³³ and for now it is necessary only to note how uncomfortably s.213 with “intent to defraud” sits and that criminal fraudulent trading is a highly useful and fitting medium through which to punish directors- albeit with creditors’ remedies for recovery currently lacking somewhat.

According to Simester and Shute in their introductory remarks to their superbly edited work on theoretical aspects of criminal law³⁴, ‘the criminal law is an institution by which the state [sic] prohibits certain types of conduct and condemns (through both conviction and sentence) and punishes persons who violate those prohibitions.’³⁵ It is noteworthy that the criminal law both condemns as well as punishes which establishes a crucial aspect of criminal fraudulent trading which, it is submitted, is oft-overlooked as a tool of prophylaxis- beyond merely threatening to send a defendant to prison.

This condemnation is the labelling of those found guilty as “criminals” which, as Chalmers and Leverick reveal in their thorough examination of the concept of fair labelling³⁶, is extremely important for a variety of reasons. These briefly include: fairness to defendants- they are labelled as convicted of a specific crime and not something more serious; public communication- making the

²⁹ *R v Leaf* [2008] 1 Cr App R (S) 3, 16.

³⁰ Under the Criminal Attempts Act 1981.

³¹ See [4.3.2].

³² See [3.2.2] above.

³³ Chapter 5.

³⁴ A.P. Simester and S. Shute (eds), *Criminal Law Theory* (OUP, Oxford 2002).

³⁵ A.P. Simester and S. Shute, ‘On the General Part in Criminal Law’ in A.P. Simester and S. Shute (eds), *Criminal Law Theory* (OUP, Oxford 2002), 4.

³⁶ J. Chalmers and F. Leverick, ‘Fair Labelling in Criminal Law’ (2008) 71 MLR 217.

public aware of what that person has done; communication to the offender- they then know precisely what they have done wrong and the consequences of it; communication to agencies- this can put them on alert that perhaps the offender is more likely to engage in other criminal behaviour or that he or she is thereby prohibited from holding certain positions. Agencies in the context of fraudulent trading might include the Insolvency Service, Serious Fraud Office (S.F.O.), the Institute of Directors and Companies House; and finally fairness to the victim(s) of the crime committed³⁷.

Clearly as s.213 is a civil wrong it carries with it none of these attributions which s.993 criminal fraudulent trading does. Yet with such heavy reliance on “intent to defraud” and its close affinity with jurisprudence relating to dishonesty and fraud³⁸, it is strongly argued that fraudulent trading is a *malum in se* rather than one of a class of *mala prohibita*³⁹. That is to say that defrauding creditors (or anyone) is simply wrong- whether or not it is technically a criminal act under the Law. A *malum prohibita* on the other hand is an act prohibited by the criminal law because the legislature considered it correct to do so- for example, speeding or possession of cannabis⁴⁰.

That being so, it appears that the criminal law condemnation and the heavy criminal sanction which s.993(3) of the Companies Act imposes are a far better prophylactic deterrent and just reaction to fraudulent trading than s.213 of the Insolvency Act. For the avoidance of doubt, this condemnation is both in terms of Society in general (whose members may very readily become creditors) and existing creditors.

Creditors are naturally protected by this deterrent effect but also, as is set out below⁴¹, they can be reimbursed for their losses or at least parts thereof when, under the Proceeds of Crime Act 2002 process, they can through very technical means establish a proprietary claim to assets post-conviction. Failing this, and more pragmatically, they may instead recover assets by virtue of a compensation order ordered by a court.

However what is it, aside from the dishonesty and defrauding (in a general sense), that warrants as severe a punishment as that which fraudulent trading attracts under the Companies Act 2006? It has often been pointed out and indeed reiterated that neither this, nor any other white collar crime is victimless. Indeed the words of the trial judge in *R v Leaf* were thoroughly approved in the Court of Appeal when he highlighted to the defendant upon conviction for fraudulent trading that:

³⁷ Ibid, 224-239.

³⁸ Such as *R v Ghosh* [1982] QB 1053.

³⁹ Originally coined by Blackstone in his work of authority *Commentaries* at 2 Bl Comm, 420. Yet this is a distinction which still meets approval in the context of fair labelling and what roles criminal law ought to play. See P. Alldrige, ‘Making Criminal Law Known’ in A.P. Simester and S. Shute (eds), *Criminal Law Theory* (OUP, Oxford 2002), 103-120.

⁴⁰ Simester and Shute (n.34), 54-56.

⁴¹ [4.3.2].

every law-abiding citizen of this country is a victim of your crimes, in that you have denied the country substantial resources which can only mean one of two things, or perhaps a combination of the two: either the burden must be increased on the law-abiding or the resources available for proper use must be reduced.⁴²

This has also been reflected in recent years by the Government's move to legislate in this area of criminal law. For example there has been a widening of the scope of the fraudulent trading offence and also the introduction of new corporate crimes⁴³. Yet the notion of fraud and "white collar" criminality has been around for a long time as Slapper and Tombs evidence⁴⁴ for it was Edwin H. Sutherland who fathered this concept back in the 1940s. It is contended that it has only been with recent economic and entrepreneurial growth, as well as a wide relaxation on the rules governing company formation that has seen a fairly recent surge in the detection and prosecution of corporate fraudulent behaviour and fraudulent trading as a part thereof.

It is therefore submitted that the criminal law rather than the civil law route is the best method of ensuring compliance and preventing not only creditor but also societal harm as the judge's remarks in *R v Leaf* attest to.

This argument is reinforced immeasurably when one now considers that punitive damages under s.213 civil fraudulent trading are no longer permitted⁴⁵. Indeed, from its very beginnings, both civil and criminal provisions have had a distinctly punitive flavour as Maugham J in *Re William C. Leitch Brothers Ltd*⁴⁶ attested to; remarking in making an assessment of the director's unlimited civil liability that the dual provision, 'is in the nature of a punitive provision'⁴⁷.

Finally, as the Company Law Review Steering Group evidenced, fraudulent trading also attends to an important public law function in that, '[c]riminal offences have the effect of concentrating the minds of members of the regulated community and also have the benefit of active enforcement by agencies required to operate in the public interest, rather than the pursuit of personal ends.'⁴⁸ The criminal law is therefore overall a far more appropriate tool and indeed weapon in preventing and dealing with fraudulent trading.

⁴² (n.27), 16-17.

⁴³ See [2.2.4] above.

⁴⁴ Slapper and Tombs (n.12), 3-16.

⁴⁵ See [3.4.1].

⁴⁶ (n.26), *ibid*.

⁴⁷ (n.26), 79.

⁴⁸ The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy: Final Report (Volume I, 2001)*, para [15.19].

4.3-Practical comparisons

4.3.1- Procedure

It has been noted that s.213 of the Insolvency Act has the added restriction of allowing only liquidators to pursue actions when compared to its statutory sibling⁴⁹. This is even more noteworthy since it was only a fairly recent restriction- to coincide with the bifurcation of criminal and civil provisions into separate statutes. Having surmised that this was in fact a correct and proper restriction on s.213 actions, we must now examine the restrictions on creditors as far as s.993 of the Companies Act is concerned. Yet, attention must be drawn to a **further** restriction on bringing s.213 actions. It is trite law that most civil actions must occur within six years of the behaviour to which the action relates and s.213 is of course no exception⁵⁰. This is highlighted as yet another restriction on the use of s.213 whereas naturally s.993 of the Companies Act can be used any time after the offending behaviour and it can even be used prior to the winding up of the company in stark contrast to s.213.

In terms of a creditor's *locus standi* and criminal actions, section 993 is straight-forward in that almost always the Crown Prosecution Service (C.P.S.) or the Director of Public Prosecutions (D.P.P.) will bring criminal actions and then it is on behalf of the Crown.

However, unlike s.213, a private prosecution may **theoretically** be brought⁵¹- and although this is a quirk of the Law whose conceptual existence is defended by the Courts⁵², it has never happened in the context of fraudulent trading for such action is in practice precluded given the very expansive duty of the D.P.P. to take over such a prosecution⁵³. Furthermore, the C.P.S. often will take over a potential case and stop it in its tracks if there is no realistic possibility of conviction and they cannot be prevented from doing so- as in *R (on the application of Gujra) v Crown Prosecution Service*⁵⁴.

Where there is a realistic possibility of conviction, then the C.P.S. will almost certainly have brought it themselves unless it is not in the public interest. Yet it is strongly argued that cases of fraudulent trading always would be. Indeed, Sedley LJ held that private prosecutions tend to prove their value only, 'from time to time'⁵⁵.

⁴⁹ At [3.3.2].

⁵⁰ Keay (n.11), 38-39. Set down in the Limitation Act 1980.

⁵¹ Under the Prosecution of Offences Act 1985, s.6.

⁵² Best espoused by Richards LJ in *R v Rollins* [2010] 1 All ER 1183, 1191-1193.

⁵³ J. Richardson Q.C. (ed), *Archbold: Criminal Pleading, Evidence and Practice 2011* (59th edn, Sweet & Maxwell 2010), [1-327].

⁵⁴ [2011] EWHC 472 (Admin).

⁵⁵ *Interbrew SA v Financial Times Ltd* [2002] EMLR 24, [22]. On private prosecutions and criticism of them see Law Commission, *Consents To Prosecution* (Law Com No. 255, 1998), 12-14 and 27-48.

The fact that the Crown will be prosecuting also has further advantages in that the end sum that creditors may receive stands to be larger because the C.P.S. and/or D.P.P. will be paid out of public and not creditors' "assets pot" funds. Therefore the cost of liquidator fees for the action is saved and the fact that, in the event that the criminal case is lost, it will be the Taxpayer rather than the liquidator who will suffer loss.

Another peculiarity in criminal law which could potentially be utilised to creditors' advantage must also be considered for completeness. This is where the fraudulent trading is not actually completed in the *actus reus* sense, but nonetheless the defendant has sought and intended to commit fraudulent trading. This could be, for instance, where X sets up a legally formed but bogus company simply for the purpose of obtaining goods, services or monetary assets on credit and then dissipating them with the company subsequently folding- known as "long firm fraud". If a creditor is approached but knows X to be a rogue and subsequently denies X credit, as a result thereof, X may be guilty of attempting to commit fraudulent trading.

This attempted liability is incurred under the Criminal Attempts Act 1981 though there are two main stipulations. Firstly, the fraudulent trading must be of an indictable level⁵⁶. That is to say that it would be tried only in the Crown Court due to its seriousness. The second is the *mens rea* which would be the intention to defraud. As already evinced, this can be problematic and indeed, it has been suggested that, 'The mental element required to make a man guilty of an attempt to commit an offence is often, if not invariably, greater than that required for the full offence'⁵⁷. However, it is not impossible given that a similar *mens rea* must be proven in cases of attempted theft and this is unusual but not unseen as an offence.

Yet this suffers from the same drawback as the omission of "in the course of winding up" in s.993 fraudulent trading in that the creditors will require knowledge of the circumstances surrounding the attempted or actual fraudulent trading in order for these advantages to be effective. In the example above, the creditor must know that X is a rogue to refuse him credit for if the creditor provides credit then *prima facie* it will be actual and not attempted fraudulent trading. Yet, given the increasing sophistication of credit checking, identification and referencing, it is suggested that attempted instances of fraudulent trading are more likely than not to increase.

⁵⁶ Section 1(4).

⁵⁷ Richardson (n.53), [17-42].

Moving on from the initiation of proceedings, Farrell, Yeo and Ladenburg highlight that s.993's procedural utility is not to be underestimated in that it, 'may incorporate multiple victims and transactions which may otherwise result in long and complicated indictments.'⁵⁸

So as is very often the case⁵⁹, where there is a range of victims, offending behaviour and other parties are involved, the procedure is simplified under this one charge and this saves vast amounts of time and money in costs which the Courts are both preciously short of. Indeed Keay highlights in extremely illustrative terms, taking a long-term overview of both types of provision that, '[w]hile civil cases have not been numerous at **any** stage of the history of the fraudulent trading provisions, there have been quite a reasonable number of criminal prosecutions.'⁶⁰

As outlined in the introductory chapter of this thesis⁶¹, s.993 fraudulent trading is very well-received by the C.P.S. due to its utility in capturing a wide range of fraudulent behaviour and this can be highlighted through the vast range of types of fraud in the caselaw. In *R v Smallman*⁶², for example, a couple defrauded both students and the Department for Education and Skills over a long period of time through their devious exploitation of an education scheme. Students would pay the defendants' company for courses which provided worthless bogus qualifications and then the defendants would make fraudulent claims from the Department's scheme. By so doing, they further fraudulently obtained funds for students who had never been entitled to receive money from the scheme or who had left.

The very same charge under s.993 of the Companies Act was brought against two directors and a *de facto* company accountant (note **not** a director) who obtained credit in the region of between £2-2.5 million in full knowledge that there was little or no chance of it ever being repaid⁶³.

Finally, s.993 was also used successfully in one of the most recent fraudulent trading cases⁶⁴ to prosecute a defendant following a carousel fraud⁶⁵ which had left Her Majesty's Revenue and Customs (H.M.R.C.) with lost taxes of circa £5 million.

⁵⁸ Farrell, Yeo and Ladenburg (n.10), 82.

⁵⁹ As in for example- *Attorney General's Reference (No.s 57 and 58 of 2003)* [2003] EWCA Crim 3893, *R v Smith (Wallace Duncan) (No.1)* [1996] 2 BCLC 109 and *R v Scragg (Michael Garrett)* [2006] EWCA Crim 2916.

⁶⁰ Keay (n.11), 27 [my emphasis].

⁶¹ [1.1].

⁶² [2010] EWCA Crim 548.

⁶³ *R v Waite (Arthur Frank)* [2003] EWCA Crim 1560.

⁶⁴ *R v Takkar (Harjit Singh)* [2011] EWCA Crim 646.

⁶⁵ Carousel fraud is a complex fraudulent scheme which in very plain terms is where several fraudulent businesses buy and sell goods to one another in a "carousel" without paying any V.A.T.- illegally pocketing the V.A.T. for themselves.

These three examples clearly highlight the very wide-ranging application of the provision and thus its utility in being able to capture an extensive array of fraudulent behaviour.

4.3.2- Dealing with defendants

Once the procedural steps of bringing a defendant before a civil or criminal court have been accomplished, and the trier of fact has found them liable, the next and most important stage of the entire process it is contended, is dealing with the defendant.

Naturally under s.213 civil fraudulent trading there is only a very narrow range of possible steps which can be taken. First and foremost is the personal liability of defendants to contribute to the company's assets⁶⁶ - whether they be an actual natural person or a company. As discussed above⁶⁷, since the *Morphitis v Bernasconi* decision, no punitive element may be added to any damages awarded by a civil court. Therefore the maximum sum for which a defendant may be held liable is that which he, she or it defrauded from creditors.

A secondary, and vitally important consequence of being held liable under s.213 if the defendant is a director, is their subsequent disqualification. This is significant both of in terms of public protection and in preventing the reoccurrence of the proscribed behaviour where the defendant is a director. It is the Disqualification of Directors Act 1986⁶⁸ which provides for disqualification and this can be for any period up to a maximum of 15 years.

These consequences are in stark contrast with s.993 of the Companies Act for a convicted defendant may face up to ten years imprisonment and/or a fine⁶⁹. This, as already highlighted⁷⁰, is a tremendously hefty punishment and evinces the extreme seriousness with which the crime is treated.

Furthermore, under s.993 if the defendant is a director, they will almost certainly face disqualification as well- in common with civil fraudulent trading. Indeed, as Ramage points out, the Crown will almost always push for disqualification where it has not been ordered by the sentencing judge given the duty of the court under s.6 of the Company Directors Disqualification Act 1986⁷¹.

⁶⁶ Under Insolvency Act 1986, s.213(2).

⁶⁷ At [3.4.1].

⁶⁸ The relevant provision for s.213 of the Insolvency Act is s.4.

⁶⁹ Companies Act 2006, s.993(3).

⁷⁰ Above at [2.2.4].

⁷¹ S. Ramage, 'Fraudulent Trading' (2009) 189 Criminal Lawyer 1, 1-2.

In terms of asset-retrieval, s.993 has a number of adjunctive remedies which are now widely employed across the spectrum of the criminal law for confiscating and redistributing assets and, in addition, the C.P.S.'s own sentencing guidance⁷² also recommends trying to persuade the Courts to impose, where appropriate, a financial reporting order. Financial reporting orders are a fairly recent innovation⁷³ and essentially force the person subject to the order, which can last for up to 15 years, to make regular and very detailed reports of their financial affairs. This is then checked by the Serious Organised Crime Agency, the Police or H.M. Revenue and Customs with severe penalties if there are any discrepancies found⁷⁴.

Under the general criminal law the mainstay of disgorging defendants of their ill-gotten gains however is confiscation⁷⁵ stemming from procedures under the Proceeds of Crime Act 2002. Yet this very broad and draconian order is severely limited in the context of s.993 creditors. As Bagshaw highlights in his briefing for practitioners, the Courts are under a **duty** to make an order where it is found that a defendant has benefitted from his criminal conduct⁷⁶. This of course stems from the centuries-old maxim in Law that no one is to be permitted to benefit from their own criminal conduct⁷⁷. Naturally, the conduct that a defendant has been found guilty of under s.993 of the Companies Act imposes this duty on the Courts. There is however leeway to permit civil proceedings and depart from this duty- such as if a s.213 civil fraudulent trading action has already been commenced⁷⁸. However, the obvious point must be made that in most cases, assets or property recovered under the Act go into public funds or to the Crown in one form or another via the relevant enforcement authority trustee.

Turning back to the remedies which will convey assets back to the defrauded creditors, the main process is the system of compensation orders obtainable under ss.130-134 of the Powers of Criminal Courts (Sentencing) Act 2000 and these can replace civil damages; although with double-recovery explicitly prevented⁷⁹.

⁷² The Crown Prosecution Service, 'Sentencing Manual: Fraudulent Trading' <http://www.cps.gov.uk/legal/s_to_u/sentencing_manual/fraudulent_trading/index.html> accessed 2nd May 2011.

⁷³ Set out under the Serious Organised Crime and Police Act 2005, chapter 3.

⁷⁴ See further- D.A. Thomas (ed), *Current Sentencing Practice* (Looseleaf Sweet & Maxwell, London), part J.

⁷⁵ For the confiscation of criminally gained assets generally both here and abroad see S.N.M. Young (ed), *Civil Forfeiture of Criminal Property: Legal Measures for Targeting the Proceeds of Crime* (Edward Elgar Publishing, Cheltenham 2009).

⁷⁶ D. Bagshaw, 'Proceeds of Crime Act 2002 and Third Party Rights' (2008) 4 St. Philips Commercial Brief 4 <http://www.st-philips.com/StPhilips/nmsruntime/saveasdialog.asp?filename=commercial_final%2Epdf> accessed 30th April 2011.

⁷⁷ See Lord Woolf MR's remarks in *Attorney-General v Blake* [1998] Ch 439, 462 (approved by the House of Lords- [2001] 1 AC 268, 276-277).

⁷⁸ Proceeds of Crime Act 2002, s.6(6).

⁷⁹ Powers of Criminal Courts (Sentencing) Act 2000, s.134.

At first blush, one might logically conclude that creditors' assets would thus end up in centralised public funds rather than being actually recovered in a s.213-esque manner. This is because a prosecutor will often open proceedings by asking a court to make a restraint order⁸⁰. This is pursuant to s.41 of the Proceeds of Crime Act and it prevents a defendant from ferreting away their ill-gotten gains. Furthermore, it prevents third-parties and thus creditors from recovering any assets or other realisable property. The prime example of this in the context of s.993 of the Companies Act is *R v Adewunmi (Robert Morayo)*⁸¹ where a restraint order made following a conviction for fraudulent trading was not adhered to and the defendant was punished further.

As the learned authors of the main authoritative work on the area of proceeds of crime point out, the Law must strike a very difficult balance between preventing third parties running off with assets but also ensuring that they do not lose out either⁸². This balancing act is starkly highlighted in the case of *Director of the Serious Fraud Office v Lexi Holdings PLC*⁸³. The Court of Appeal held that creditors **may**, in restricted circumstances, be permitted to recover assets owed to them when the assets are subject to a restraint order. This is by way of removing them from those subject to a restraint order before the public body (in that case the S.F.O.) takes their share for public funds.

This can occur only when, 'there is no conflict with the object of satisfying any confiscation order that has been or may be made'⁸⁴ or where a proprietary claim can be made. Quickly noting this second part could lead one to mistakenly think that this allows secured creditors (who, by virtue of their security, have a proprietary interest) to recover. However, unless it is a creditor (almost always a bank) who has secured their debt against a **personal** guarantee from the defendant, then this cannot occur. Also, it is highly likely that these types of loan would have been recalled by this stage anyway.

The proprietary interest of secured creditors in the context dealt with in this thesis lies in the company or vehicle used for fraudulent trading. For example a typical secured creditor here would be a bank which has a floating or fixed charge and this is against the company's assets and not the director's/manager's. There is no recorded case of a company being convicted of fraudulent trading

⁸⁰ T. Millington and M. Sutherland Williams, *Millington and Sutherland Williams on the Proceeds of Crime* (3rd edn, OUP, Oxford 2010), 15. On restraint orders generally, see chapter 2 of the same work.

⁸¹ [2008] 2 Cr App R (S) 52.

⁸² Millington and Sutherland Williams (n.80), 431.

⁸³ [2009] QB 376.

⁸⁴ *Ibid*, 404.

and whilst theoretically possible⁸⁵, there is extremely unlikely to be one as pragmatically there is no point as the company may be about to be or has been wound up.

Therefore, the bottom line is that secured creditors, by virtue of their security *per se*, cannot establish proprietary interests against the defendant and so cannot remove their assets from those under a restraint order. One extremely difficult method which is open to both secured and unsecured creditors is that of establishing a constructive trust, yet this is almost always too costly and too complex by virtue of the idiosyncrasies and peculiarities of Equity.

This therefore leaves creditors, especially those which are unsecured in a rather difficult position at the bottom of the pile as Millington and Sutherland Williams evince in their superb summary of the position of creditors during proceedings⁸⁶. However, this is not particularly unexpected given that they are also at the bottom of the pile when it comes to distributing assets in a normal liquidation process.

Yet, the harshness of the court's ruling⁸⁷ is tempered somewhat by Keene LJ as again noted in *Millington and Sutherland Williams on the Proceeds of Crime*⁸⁸. He opines that compensation orders serve to soften the blow for creditors⁸⁹. Indeed, his remarks may be even more insightful than he perhaps first anticipated given the fact the Legal Aid, Sentencing and Punishment of Offenders Bill provides that the Courts will be compelled to consider compensation orders rather than merely having the option of doing so⁹⁰.

Furthermore, Millington and Sutherland Williams make it abundantly clear that, 'prosecuting authorities are very conscious of the difficulties that restraint orders can cause to innocent third parties and, in so far as the legislation allows, endeavour to deal with them fairly and in a way which takes account of their property rights.'⁹¹ Indeed, this has been backed up by the experiences this author has been recounted by both solicitors acting for third parties and counsel who prosecute fraud cases and deal with Proceeds of Crime Act work.

This appears not to be dissimilar to s.213 Insolvency Act proceedings. However there are two crucial advantages which this process encompasses. First, it relates to the nature of the agencies used to

⁸⁵ Contrasting with a company being held liable under s.213.

⁸⁶ Millington and Sutherland Williams (n.80), 12-13.

⁸⁷ Which was based upon the statutory interpretation of the Proceeds of Crime Act 2002, s.69. See also P. Fellows and H. Fellows, 'The Real Hustle: Restraint, Confiscation Orders and Civil Enforcement' (2010) 21 Hardwicke Property Newsletter 1 <<http://www.hardwicke.co.uk/media/42/242-hardwicke-march-property-newsletter.pdf>> accessed 8th August 2011.

⁸⁸ Millington and Sutherland Williams (n.80), 441.

⁸⁹ [2009] QB 376, 402-403.

⁹⁰ Legal Aid, Sentencing and Punishment of Offenders HC Bill (2010-2011) [205], cl. 53.

⁹¹ Millington and Sutherland Williams (n.80), 463.

investigate and recover the assets in that they are publicly funded. They are also normally much larger and better-resourced than liquidators and able to cooperate much more easily with the Police, Asset Recovery Agency and H.M.R.C. in investigating where the assets may have gone and then realising them.

Therefore, creditors are perhaps more likely (through use of better resources) to receive an even greater amount of recovered assets as the “asset pot” will only have reasonable liquidator and financial professional costs deducted for the time the assets spend in the trust.

Secondly, under s.84(2)-(2)(d) of the Proceeds of Crime Act, property which may be realised **includes** the property vested in a bankrupt’s trustee. Therefore if a defendant is a person who has been made bankrupt, as may very well be the case if they have defrauded creditors of very large sums, even after they are made bankrupt, the property now in the hands of the bankrupt’s trustee is taken into account for determining the amount available to be taken away.

This therefore potentially allows money/assets to be recoverable even when the perpetrator is bankrupt- such a situation would never arise in a recovery action under s.213. It is admitted that this is fairly radical and draconian, yet the ability to pursue a defendant even after he or she is in a state of bankruptcy has an important prophylactic effect as it firmly discourages the casual and/or malicious placing of assets beyond recovery by defendants when they know that “the game is up”.

Furthermore, we can glean from the voluminous caselaw that confiscation orders are frequently made in s.993 fraudulent trading cases. Then through bearing in mind that compensation orders take priority and that assets may already have been removed from the restraint order “pot”, it is easy to infer that creditors do recover significant amounts overall.

Cases such as *R v Robertson (Mark)*⁹² provide examples of the regular appeals against confiscation orders in s.993 cases. Yet whilst judges recognise the somewhat harsh nature of these penalties when used in conjunction with imprisonment, the fact that the Proceeds of Crime Act 2002 is intended to disgorge criminals of their ill-gotten benefits seems to override this concern⁹³. *R v Grainger (Mark Barrington)*⁹⁴ and *R v Linda Straughan*⁹⁵ highlight however that there must be a nexus between the fraudulent trading and some form of benefit to a defendant- no benefit evidenced means no asset removal. *Grainger* is of further note however as whilst it was held that the main defendant Mr. Grainger had not obtained a criminal benefit from his fraudulent trading, his

⁹² [2006] EWCA Crim 1289.

⁹³ *Ibid*, [46].

⁹⁴ [2008] EWCA Crim 2506.

⁹⁵ [2009] EWCA Crim 955.

co-defendant had a confiscation order of 1p made against him. This was because he had no realisable assets but in anticipation that assets would subsequently be discovered, the prosecution “preserved its position” so that they would be immediately recoverable upon discovery⁹⁶.

This therefore highlights the utility of confiscation orders in that even when a defendant attempts to place assets into Swiss bank accounts or beyond the reach of the relevant agencies, he or she will always find that an extremely close financial eye will be kept on them so that if assets are hidden, they will eventually be quickly and effectively realised. Yet, unfortunately for creditors, they have to intervene early on in order to recoup assets for themselves rather than public funds.

4.3.3- The widened expanse of s.993 of the Companies Act 2006

An immense advantage of s.993 as outlined above⁹⁷, is that *per* s.9 of the Fraud Act 2006, it has vastly wider scope than s.213 civil fraudulent trading in that it can now be enforced against sole traders and those, ‘outside the reach of s.993 of the Companies Act 2006’⁹⁸. This as commentators emphasise, ‘represents a significant change in the law.’⁹⁹

This extension was to encapsulate those who carried on their fraudulent trading-esque business activities through a non-corporate vehicle. This can include sole-traders, partnerships and trusts- the main reasoning being, according to the Law Commission’s Report is that it would, ‘be a logical and [procedurally] useful step’¹⁰⁰ that whatever the vehicle used, the perpetrator could still be prosecuted. Furthermore, it has also been pointed out¹⁰¹ that scams and certain types of complicated frauds were also the target of a widened s.993 as they previously only came under the remit of “conspiracy to defraud”- which naturally as a conspiracy required more than one perpetrator to be useable.

This highlights both the utility in prophylaxis and prosecution of s.993 of the Companies Act as well as reminding us of the very close nexus between fraudulent trading both conceptually and jurisprudentially and common law conspiracy to defraud.

⁹⁶ (n.94), [2].

⁹⁷ At [2.2.4].

⁹⁸ Fraud Act 2006, s.9(2)(a).

⁹⁹ Farrell, Yeo and Ladenburg (n.10), 72.

¹⁰⁰ Law Commission, *The Effective Prosecution of Multiple Offending* (Law Com No. 277, 2002), 79.

¹⁰¹ Farrell, Yeo and Ladenburg (n.10), 75-76.

To reiterate, a further possibly more significant change which underlines the utility and effectiveness of criminal fraudulent trading in, 'provid[ing] a valuable weapon in countering crime'¹⁰², was the increase in maximum term of imprisonment up to ten years- placing it on a equivalent level to very serious offences indeed¹⁰³. It also calls into question Keay's assertion that, 'it is less serious than a specific charge of theft or fraud for an equivalent amount'¹⁰⁴.

Overall therefore, s.9 of the Fraud Act 2006 has only added to the immense flexibility, utility and effectiveness of s.993 criminal fraudulent trading. This, in turn, therefore widens the gap in all of these areas even further between it and s.213 of the Insolvency Act and overshadows civil fraudulent trading in its application as a legal and procedural tool.

4.4-Conclusion

In this chapter, the contrasting aspects of s.213 civil and s.993 criminal fraudulent trading have been unpicked and explored using both a jurisprudence- and a practice-based analysis. From the comparisons made above, and indeed throughout this thesis, several conclusions may be reached.

Firstly, fraudulent trading has evolved and changed as corporate governance has tightened and, from comparisons of the two separate provisions, it is contended that s.993 of the Companies Act is much better placed to govern and guide putative defendants' behaviour.

Secondly, since the Powers of Criminal Courts (Sentencing) Act 2000 and the ability, albeit it very limited, under the Proceeds of Crime Act 2002 process for creditors to seize restrained assets, the process of asset retrieval for creditors is no longer strictly and narrowly constrained to civil courts. Instead, the Courts are actively encouraged to deprive criminals of their ill-gotten gains and certain pragmatics mean that creditors could potentially be better off under s.993. However, there are gaps which need addressing in order for this to become more effective¹⁰⁵.

¹⁰² The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy: Final Report (Volume 1, 2001)*, para [15.7].

¹⁰³ See [2.2.4].

¹⁰⁴ Keay (n.11), 40. (Although it must be borne in mind that his work was published only just after the Fraud Act 2006 was enacted).

¹⁰⁵ An issue addressed in the next and final chapter.

It has also been shown that civil fraudulent trading and specifically the notion of “intent to defraud” has been built upon ostensibly criminal law notions which have been inappropriately applied to civil law cases since the bifurcation of the provision in 1985.

Overall therefore it must be posited that s.993 of the Companies Act 2006 is both much more useful pragmatically and sits much more comfortably with the fraudulent trading provisions’ developmental jurisprudence than its s.213 Insolvency Act counterpart.

Chapter Five:

Fraudulent Trading- What Are We To Do?

5.1-Introduction

This final chapter will tentatively suggest and look at the future direction of fraudulent trading- in terms of both civil and criminal provisions. It is fairly concise as the arguments and rationales behind this submission as to fraudulent trading's future are drawn from this thesis' entire content. It will be argued that, despite reservations surrounding s.213 of the Insolvency Act 1986, civil fraudulent trading is still a viable and useful tool for liquidators- for now at least. The importance of s.993 of the Companies Act 2006 will be reiterated and then future developments and alterations to the workings of both sections will be posited.

5.2-Section 213 of the Insolvency Act

5.2.1- The advantage of its range

This provision, as has been shown throughout, does undoubtedly suffer from procedural¹, pragmatic² and jurisprudential³ problems. However, its utility and flexibility should not be underestimated as a vital implement in the toolbox of liquidators.

The reason it is so very useful is its unique and unrivalled ability to capture third parties and force them to contribute to the "assets pot". It has been shown⁴ that other remedies are neither wide-ranging nor effective enough to fill the void that may be left by any removal of the civil fraudulent trading provision.

Its ability to encapsulate third parties is useful as the main remedies afforded to liquidators almost always allow only directors to be pursued for misdemeanours occurring in a company's "twilight

¹ Most of which are shared with s.214 wrongful trading- [1.3.5].

² Most starkly highlighted at [1.3].

³ See [2.3.3], [3.2] and [4.2.2].

⁴ In chapter one.

zone". Directors, whilst often the most favourably remunerated in companies, are not always that useful in terms of liquidators' targeting in the aftermath of a company's insolvency and collapse.

Assets are often stashed away in trusts or are unrealisable through being put into the legal ownership of other people- with directors' family and friends usually being the preferred choice, and so cannot be pursued. Also worth bearing in mind is the fact that large secured creditors such as banks with personal guarantees from directors (in contrast to those secured on the company they run's assets) may well have already stripped out assets before proceedings by liquidators are commenced. Normally directors provide personal guarantees against their homes and so already a potentially major asset is beyond seizure.

Third parties on the other hand can include other higher value individuals (in terms of assets) who may not have had the presence of mind to conceal or put assets beyond the reach of liquidators- for why would they bother if they did not consider themselves a target of liquidators' proceedings? Even more usefully, and probably more relevant in the current context, "third parties" crucially encapsulates other companies. They will almost invariably have far more assets than an individual and, significantly, they will be accessible to any liquidator who successfully manages to bring them into the fold of a s.213 action.

It is strongly argued that it is this distinguishing feature which heavily mitigates the drawbacks of civil fraudulent trading.

5.2.2- Arguments against s.213

Having established this utility, it must be contrasted with the main problem which befalls s.213- that of the "intent to defraud" element. The problematics of this element have already been well-rehearsed throughout this thesis, but this begs the question of why not simply expand s.214 wrongful trading to encapsulate the putative third party defendants of civil fraudulent trading?

Prima facie this would appear to be the panacea for liquidators, and one which could be implemented relatively easily. However this would, like most supposed cure-alls, overlook major and fundamental problems which render the solution both unworkable and impractical.

Having set out the drawbacks of wrongful trading, it must be recalled that the reasoning behind a lower threshold but narrower class of persons potentially subject to s.214 was espoused⁵. To widen

⁵ At [1.3] above.

the remit of s.214 wrongful trading would upset this delicate balance and expose a far wider field of putative defendants to a lower standard of behaviour required to hold them liable. This would in turn, it is contended, upset the commerciality of the credit world and make secondary lenders, managers and others associated with the running of companies in times of financial difficulty very wary indeed. In turn, this could therefore have damaging economic consequences; driving up costs for already hard-pressed companies.

Indeed, Lord Hoffmann echoed this sentiment when he warned of the dangers of too open-ended and expansive liability in *Aktieselskabet Dansk Skibsfinansiering v Brothers*⁶ - a case concerning Hong Kong's fraudulent trading provision (a copy of the United Kingdom's). He noted that flexibility and great caution were to be observed so as not to impinge upon commerciality and this was re-iterated in one of the High Court decisions in the *Morris v Bank of India* litigation⁷ where Patten J held, 'it is clear... that even in civil proceedings the Court needs to be more sure about finding serious allegations⁸ proved than it might require to be in relation to less serious matters.'⁹

Indeed, this second comment is even more pertinent when one considers that *Morris v Bank of India* involved third party liability as well. Therefore the Courts are keen on holding on to the notion of fairly restrictive liability for fraudulent and wrongful trading. The restrictive nature (relatively speaking) of the latter provision can be seen when one considers the judicial mood towards potentially expanding the remit of shadow and *de facto* directors¹⁰.

This constrained approach towards expanding wrongful trading "via the back door" is another indication of the unworkability and undesirability of expanding wrongful trading to allow liquidators to recover from third parties.

A final observation must be made in that civil fraudulent trading has held firm on the Statute Book for almost 90 years which itself is quite a feat given the rapid expansion and evolution of insolvency law¹¹. In fact, it must be noted that the Cork Committee called for the removal of what was then to become s.213 of the Insolvency Act 1986¹², yet the provision still persists. This leads to the inexorable submission that it still therefore presents a useable and practical tool for recouping the assets of creditors. The fact that its role has changed slightly in that it is no longer to contain any

⁶ [2001] 2 BCLC 324. See further [2.3.4].

⁷ [2003] BCC 735.

⁸ Such as fraudulent trading- as was the case in that litigation.

⁹ (n.7), 746.

¹⁰ Evincing at [1.3.6].

¹¹ On the history and development of the area see V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP, Cambridge 2009), chapter 1 and I.F. Fletcher, *The Law of Insolvency* (3rd edn, Sweet & Maxwell, London 2002), [1-012]-[1-018] and [1-024]-[1-039].

¹² See above [2.2.1]-[2.2.2].

punitive element does not and should not distract from its main function to reach beyond directors and capture the assets of unsuspecting, but nonetheless culpable third parties. Whilst perhaps one of the measures of last resort, it is nonetheless a valuable one.

Overall it is argued that the future of s.213 fraudulent trading, whilst not assured forever, is certainly secure until Parliament provides for a more expansive role for civil recovery post-conviction; either through widening compensation orders or the Proceeds of Crime Act 2002 regime. The current inconsistencies and undesirability of “intent to defraud” are difficult to remedy without removing the higher hurdle which must be met so as not to damage commercial interests. Unless and until such issues can be addressed in a full and thorough Cork Committee-like reassessment of the provision, it is undoubtedly here to stay.

5.3-Section 993 of the Companies Act

5.3.1- An assured presence

Its rapid change and transformation since the bifurcation of the two fraudulent trading provisions has seen s.993 of the Companies Act go from strength to strength in practical terms. Section 993 is undoubtedly secure in its role as a means of deterring and also punishing fraudulent trading behaviour through the Criminal Courts. There is a wide variety of factors which all point towards this reality. These factors include that its role and remit has been vastly widened since its separation from civil fraudulent trading in 1985¹³, that punishment for being found guilty of criminal fraudulent trading has vastly increased, and the general regular usage of the section.

Indeed, it is held in high esteem by criminal practitioners as a handy and expansive provision which usefully cuts down the number of charges and avoids the area of “conspiracy” which can prove tricky. The single most obvious indication of criminal fraudulent trading’s width and utility is the C.P.S. guidance in which prosecutors are encouraged to charge fraudulent trading under s.9 of the Fraud Act 2006 which has greatly extended the range of s.993 where:

¹³ On this widening, see [2.2.4].

an individual conducts a “long firm fraud”¹⁴;

a business has continued to trade and run up debts knowing that there was no reasonable prospect of those creditors ever being paid;

a business is being run for a fraudulent purpose, for example, rogue “cold calling” traders who regularly submit inflated bills to customers for shoddy work (and who often target the elderly or vulnerable).¹⁵

The features of s.993 enunciated throughout this thesis highlight its prevalence *per se* as well as the reasons behind this as a weapon of choice against those defrauding creditors. Furthermore, the current economic climate and extreme caution of creditors only serves to drive up the frequency of its usage.

There has undoubtedly been a dramatic increase in s.993 actions in recent times and it is very often coupled with Proceeds of Crime Act 2002 proceedings- as can be gleaned from the rise in appeals against confiscation orders following conviction for fraudulent trading. With its effectiveness and essentially problem-free jurisprudence, it is this latter part of post-conviction procedure that provides the most moot area as to the future of s.993 fraudulent trading. These two areas cannot be separated for the continued success of criminal fraudulent trading and its *raison d’être* both flow from the protection of creditors from errant behaviour **and** providing them with a pathway to recover assets under general legislation aimed at removing assets from criminals and returning them to the victims of their crime(s).

5.3.2- The future of creditors’ remedies under criminal fraudulent trading

It has been evinced that whilst fraudulent trading under s.993 of the Companies Act 2006 is good at prosecuting and punishing deviant and fraudulent behaviour by directors and third parties, it does not always provide a direct and easily-obtainable remedy for creditors¹⁶. The need to either establish a proprietary interest to remove assets from those under a restraint order (which could end up involving the messy area of constructive trusts) or to be largely dependent upon a prosecutor’s and/or judge’s discretion is far from ideal.

¹⁴ Whereby an individual sets up a legally formed but bogus company solely for the purpose of obtaining goods, services or monetary assets on credit and then dissipates them with the company subsequently folding.

¹⁵ The Crown Prosecution Service, Legal Guidance: The Fraud Act 2006’
<http://www.cps.gov.uk/legal/d_to_g/fraud_act/#a27> accessed 29th August 2011.

¹⁶ See above at [4.3.2].

It is submitted that there may be a redressing of the balance in favour of creditors for two significant reasons. First, Parliament's push for the mandatory consideration of compensation orders upon the sentencing of offenders¹⁷ and second, the judicial recognition of the plight of unsecured creditors within the post-conviction asset recovery regime in the central *Lexi Holdings* case¹⁸. This redressing will perhaps occur in the form of a relaxation of the strictness of the *Lexi Holdings* ruling through a further case brought before the Court of Appeal or possibly the Supreme Court, or alternatively by prosecutors and potentially the judiciary being forced to consider the interests of creditors in fraudulent trading and general fraud cases.

The position at the moment is that a lack of success in establishing a proprietary interest in a convicted fraudster's assets leaves creditors entirely at the mercy of a court's procedure post-conviction. It is argued that a change, similar to one proposed and due to appear on the Statute Book *vis-à-vis* compensation orders, could quite easily and rapidly be effected.

The only foreseeable objectors would be those who had fallen foul of s.993 and with a maximum sentence of ten years imprisonment and the Proceeds of Crime Act 2002 procedure available and frequently utilised, the previous Government and Parliament have made clear their intentions towards those convicted of fraudulent trading.

Overall therefore, it is tentatively contended that the future of criminal fraudulent trading is assured as it presently stands in the Companies Act (as amended by the Fraud Act), yet the post-conviction procedure and retrieval of assets process for creditors will become more relaxed in their favour. This may then, in turn, contribute to the decline in the use of s.213 civil fraudulent trading.

5.4-Section 213 of the Insolvency Act- Here To Stay?

Yet, notwithstanding any changes to post-conviction procedures with respect to the position of creditors, we must also consider the possibility that for whatever reason, the Crown¹⁹ may decide not to prosecute an instance of fraudulent trading.

Prima facie, this could leave creditors without any remedy against third parties if civil fraudulent trading is removed. Thus there is a strongly arguable case for keeping available a separate stand-

¹⁷ Under the Legal Aid, Sentencing and Punishment of Offenders Bill HC Bill (2010–2011) [205], cl.53.

¹⁸ *Director of the Serious Fraud Office v Lexi Holdings PLC* [2009] QB 376, 402-403.

¹⁹ Through either the Crown Prosecution Service or the Director of Public Prosecutions himself.

alone civil remedy, even if in practice it will only very rarely be used. As highlighted at the start of this thesis, not even the tort of deceit fully covers the fraudulent behaviour remit of s.213 of the Insolvency Act 1986²⁰. Furthermore, as espoused earlier²¹, there is the theoretical possibility of private prosecutions being initiated but in reality this almost never occurs and after extensive searching there appears to be no record of any private prosecutions for fraudulent trading.

Any potentially aggrieved party will also be very wary of exposing themselves to the risk of being held liable for the tort of malicious prosecution if they embark upon a private prosecution²² and it is submitted that neither creditors nor liquidators would want to expose themselves to such a risk.

Therefore, the utility in retaining s.213 of the Insolvency Act as a residual remedy can be seen as it is clear that it is far better and more likely to succeed than any quirky notion of private prosecution followed by the aggrieved creditor(s) or liquidator asking for compensation upon sentencing.

If then as an ostensibly hypothetical argument, it is contended that the injured creditor or liquidator could **always** bring a private prosecution, then that is a clear and perverse instance of overzealous litigation and is just adding insult to injury. Why make a creditor or liquidator prosecute as a stepping stone to getting compensation? It is not their legal task nor something they are accustomed to and in such an instance it would be far better to simply let the liquidator (for and on behalf of creditors) bring the proceedings they²³ are interested in; i.e. a civil action. Yet, of course, that both requires and justifies the retention of s.213.

Though having highlighted throughout the criminal-esque level of liability needed to successfully make out a s.213 case, we ought to remind ourselves of the potential alternative tentatively proffered in chapter 3²⁴; that of ***“If no reasonable person in that position (if the fraudulent trading action relates to a creditor for example) could have believed what the defendant claims to believe, then the defendant will be deemed to have the requisite intent to defraud.”***

Once again, it would require a good deal of Parliamentary will to set up a committee to review the current state of the Law which, in light of current budgetary constraints, would unfortunately not be at the top of the legislative reform agenda.

²⁰ See chapter 1.

²¹ At [4.3.1].

²² An excellent example of such a case and one setting out the Law is *AH v AB* [2009] EWCA Civ 1092. See especially paragraphs [13]-[28]. Further guidance on the tort can be found at W.V.H. Rogers, *Winfield and Jolowicz on Tort* (18th edn, Sweet & Maxwell, London 2010), [19-1]-[19-11].

²³ The creditors, that is.

²⁴ [3.2.2].

Thus it can be safely said that s.213 of the Insolvency Act 1986 will be here to stay for the foreseeable future unless some form of remedy against third parties can be included in wrongful trading. This is possible given their shared heritage but it would certainly have to incorporate the suggested alternative to “intent to defraud” as a higher hurdle of liability to avoid the problems which could be caused by over-burdensome liability²⁵.

²⁵ As espoused at [1.3.4].

Final Conclusions

This thesis began by way of metaphor in relation to what creditors could do when their lent assets are put beyond reach by the fraudulent actions of directors or corporate actors. Throughout, the importance of fraudulent trading as a concept, both criminal and civil, has been emphasised to highlight the fact that it is still a very valuable one to a defrauded creditor.

Before breaking down fraudulent trading into its constituent parts and its criminal²⁶ and civil²⁷ branches, the importance of its study and place in creditor recovery has been outlined and examined. Whilst we have seen it is not necessarily at the heart of every single creditor action brought in the Civil Courts, it is always available as perhaps a slightly idiosyncratic remedy but one which can be hugely advantageous to liquidators and, in turn, creditors by inflating the “assets pot” where it otherwise might lie rather bare.

Furthermore as a criminal law provision which, almost uniquely, near-mirrors its civil law sibling, it is a popular and well-used weapon against fraudsters. It has morphed and changed rapidly *post* the Insolvency Act 1986 bifurcation of the two fraudulent trading provisions into separate statutes. Added to the inherently useful characteristics of the Criminal Law (such as punishment, labelling and retribution), this enables s.993 of the Companies Act 2006 to have an important prophylactic deterrent effect on aberrant behaviour. It is also now a very handy instrument for tackling fraud; especially given its width, criminological and procedural advantages, and prophylactic effects.

Having conducted a thorough analysis of the history and development of this unique concept in insolvency law, the constituent provisions were picked apart and revealed several telling deductions which can be made about each fraudulent trading provision separately.

Civil fraudulent trading

Dealing first with s.213, it is still perhaps slightly nebulous and hard to prove but is nonetheless useful and still used. This is because of the shortcomings in s.214 of the Insolvency Act, the tort of deceit and currently s.993 of the Companies Act in terms of asset recovery.

²⁶ Companies Act 2006, s.993.

²⁷ Insolvency Act 1986, s.213.

The difficulty with s.213 stems from “intent to defraud” being an ostensibly criminal law concept which is perhaps best dealt with by the criminal law system. Notwithstanding this, it is necessary to have a higher burden of proof accompanying a wider range of putative defendants lest the price and availability of credit will increase. Therefore simply widening s.214 would be foolhardy and furthermore it is precisely this element of dishonesty which distinguishes s.213 from s.214 wrongful trading²⁸.

Yet, the immense utility of being able to recoup assets beyond the narrow field of the board of directors is the unique attribute which fraudulent trading (both civil and criminal) possesses. Having brought in the theoretical concept of “creditor wealth maximisation”, it is easy to see how it fits in with the purported general scheme of insolvency law. Whilst there may be higher hurdles to cover, this should not detract from the use of both fraudulent trading provisions and the fact that their higher hurdles prevent overly-indulgent liability from arising and thus disturbing the delicate nature of corporate finance and credit markets.

Yet, in delving into the problematic phrase “intent to defraud” it has been argued that as a criminal law concept it is unacceptable for it to remain in s.213 of the Insolvency Act 1986. However, in postulating an alternative²⁹, it must also be recognised that Parliamentary will for change and a general review of insolvency law- akin to that of the Cork Committee would be required for such a change to be brought about given the infrequency of civil fraudulent trading.

Criminal fraudulent trading

It has been demonstrated that, having been separated from civil fraudulent trading in 1985, s.993 and its statutory predecessor³⁰ have moved fraudulent trading more from being a tool to a weapon. It, ‘provides a valuable weapon in countering crime’³¹ and although it carries a higher standard of proof than civil actions³², this is tempered by the fact that it is very wide-ranging indeed. Therefore the drastic consequences of imprisonment, being labelled as a convicted fraudster and the potential post-conviction forfeiture of assets are applied to a very wide range of persons but crucially sparingly so.

²⁸ *Bernasconi & Anor v Nicholas Bennett & Co* [2000] BCC 921, 924.

²⁹ Outlined at [3.2.2].

³⁰ Companies Act 1985, s.458.

³¹ The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy: Final Report (Volume I, 2001)*, para [15.7].

³² That of proof “beyond a reasonable doubt” is required.

This ensures that fraudulent trading behaviour, when discovered, is within the remit of the criminal law but that conviction and punishment does not occur too easily; leading to hugely undesirable over-criminalisation. It is also extremely pertinent to note that in the overwhelming majority of criminal cases, defendants plead guilty instead of being convicted after a trial. Therefore, despite the high burden of proof being *prima facie* a high barrier erected by criminal procedure, its effect in preventing criminal fraudulent trading from being used and used effectively is perhaps overstated.

In mentioning post-conviction processes, the rise of fraudulent trading in the criminal law sphere has also been coupled by the compensation order³³ and Proceeds of Crime Act 2002 regimes. These are not strictly part of s.993 *per se* but have been shown to form a key part of its role in attempting to recover assets as well as protecting creditors in a prophylaxis-type role as well.

Yet, in analysing the two methods, flaws have been found which could be remedied fairly easily. These are that all-too-often creditors' chances of recovery are left to the whim of the prosecutor and/or the judiciary and to ensure that assets are recouped for certain, the very tricky business of establishing a proprietary interest in a defendant's assets is necessary.

However, remedial steps may even be just on the horizon according to the new Legal Aid, Sentencing and Punishment of Offenders Bill³⁴ as well as a good deal of judicial sympathy towards the plight of creditors. If such changes do happen to facilitate the easier recovery of assets by creditors, then it is speculated that s.213 fraudulent trading could experience a sudden and perhaps terminal decline.

Overall, fraudulent trading is a most interesting and rare concept in crossing the civil and criminal law boundaries in a near-identical format. It has advantages and disadvantages in both arenas and its continued existence and extreme utility in one form or another is certainly assured.

43, 6481 words

H.M. Skudra

³³ Under the Powers of Criminal Courts (Sentencing) Act 2000, s.134.

³⁴ HC Bill (2010-2011) [205].

Appendix 1:

Companies Act 1928, s.75/ Companies Act 1929, s.275

Section 75/ 275

- (1) If in the course of a winding-up it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver or the liquidator, or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any of the directors, whether past or present of the company who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.
- (2) ...
- (3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in subsection (1) of this section, every director of the company who was knowingly a party to the carrying on of the business in manner aforesaid, shall be liable on conviction on indictment to imprisonment for term not exceeding one year.
- (4) The court may, in the case of any person in respect of whom a declaration has been made under the foregoing provisions of this section or who has been convicted of an offence under the foregoing provisions of this section, order that that person shall not, without the leave of the court, be a director of or in any way, whether directly or indirectly, be concerned in or take part in the management of a company for such period, not exceeding five years, from the date of the declaration or of the conviction, as the case may be...

Appendix 2:

Companies Act 1948, s.332

Section 332

- (1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct. On the hearing of an application under this subsection the official receiver or the liquidator, as the case may be, may himself give evidence or call witnesses.
- (2) ...
- (3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in subsection (1) of this section, every person who was knowingly a party to the carrying on of the business in manner aforesaid, shall be liable on conviction on indictment to imprisonment for a term not exceeding two years or to a fine not exceeding five hundred pounds or to both.
- (4) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made, and where the declaration under subsection (1) of this section is made in the case of a winding up in England, the declaration shall be deemed to be a final judgment within the meaning of paragraph (g) of subsection (1) of section one of the Bankruptcy Act, 1914.

Appendix 3:

Companies Act 1985, s.458

Section 458

If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or a fine, or both. This applies whether or not the company has been, or is in the course of being, wound up.

Appendix 4:

Companies Act 1985, s.630

Section 630

- (1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
- (2) The court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper to do so, declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are to be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.
- (3) On the hearing of the application, the official receiver or the liquidator (as the case may be) may himself give evidence or call witnesses.
- (4) ...
- (5) ...
- (6) This section has effect notwithstanding that the person concerned may be criminally liable in respect of matters on the ground of which the declaration under subsection (2) is to be made; and where the declaration is made in the case of a winding up in England and Wales, it is deemed a final judgment within section 1(1)(g) of the Bankruptcy Act 1914.

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